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IN THE

Supreme Court of the United States

OCTOBER TERM, 1966

No. 728

KAPEL GOLDSTEIN and TILLIE GOLDSTEIN, *Petitioners*

—against—

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

MAX BARNETT and ESTHER BARNETT, *Petitioners,*

—against—

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

MICHAEL J. IPPOLITO and AGNES IPPOLITO, *Petitioners,*

—against—

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

The petitioners pray that writs of certiorari issue to review judgments of the United States Court of Appeals for the Second Circuit, entered in the above-entitled cases, sustaining the disallowance of interest deductions on valid indebtedness. Judgment was entered in each case on July 22, 1966.

Opinions Below

The findings of fact and opinion of the Tax Court in *Kapel Goldstein, et al.* v. *Commissioner* are officially reported as 44 T. C. 284.

The findings of fact and opinion of the Tax Court in *Max Barnett, et al.* v. *Commissioner* are officially reported as 44 T. C. 261.

The findings of fact and opinion of the Tax Court in *Michael J. Ippolito, et al.* v. *Commissioner* are reported as T. C. Memo., No. 1965-167.

The opinions of the Court of Appeals have not been officially reported as yet.

Statute Involved

INTERNAL REVENUE CODE OF 1954

Sec. 163 (a) GENERAL RULE.—There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

* * * * *

The Facts

(Kapel Goldstein, et al. v. Commissioner*)

Tillie Goldstein (hereinafter petitioner) and her husband, Kapel Goldstein filed a joint Federal income tax re-

* The facts in the other two cases are separately stated, beginning at page 22.

turn for the year 1958 employing the cash receipts and disbursements method of accounting. In the fall of 1958 Petitioner won the Irish Sweepstakes and collected $140,218.75. In all of the transactions hereinafter described, Petitioner was represented by her son Bernard Goldstein (hereinafter Bernard), a certified public accountant, who acted as her agent.

1.

On or about December 31, 1958 Bernard purchased for petitioner $500,000 face amount U. S. Treasury Notes, 1½% due October 1, 1962 through Garvin, Bantel & Co. (hereinafter Garvin, Bantel) members of the New York and American Stock Exchanges engaged in the securities business. Garvin, Bantel were also money brokers. The purchase price was $464,687.50 plus accrued interest of $1,875.00 for a total of $466,562.50. On or about December 31, 1958 Petitioner borrowed $465,000.00 from the First National Bank of Jersey City (hereinafter Jersey City Bank) to complete the payment for the Treasury Notes. The loan was evidenced by a promissory note, signed by petitioner, due October 15, 1961 with interest at 4% per annum and secured by a pledge of the Treasury Notes. The note was with full recourse and further provided that either party could accelerate the maturity of the note after thirty days. On or about December 30, 1958, petitioner paid, by certified check, to Jersey City Bank, the sum of $52,596.61 as interest in advance to the maturity of the note.

During May, 1959, petitioner was advised that the Jersey City Bank would exercise its call privilege. On or about June 9, 1959, petitioner refinanced the Jersey City Bank loan with Gruntal & Co., securities brokers (hereinafter Gruntal) on a month to month basis. Jersey City Bank

delivered the Treasury Notes to Gruntal against payment of the note together with its check to petitioner for $42,944.61 representing a rebate of a portion of the interest previously paid by petitioner.

On or about December 1, 1959, petitioner sold the Treasury Notes for a price of $458,894.37 plus accrued interest of $1,270.49 for a total of $460,254.86 which amount was credited to Petitioner's account with Gruntal. On the same day, petitioner purchased $500,000.00 face amount U. S. Treasury Bonds, 2½% due November 15, 1961 (hereinafter Treasury Bonds) for a price of $477,109.38 plus accrued interest of $583.79 for a total of $477,693.17, which amount was charged to petitioner's account with Gruntal.

On or about February 4, 1960, petitioner sold $250,000.00 face value of the Treasury Bonds for a total of $242,657.97 including accrued interest. On or about June 13, 1960, petitioner sold the remaining $250,000.00 Treasury Bonds for a total of $247,384.51 including accrued interest. The proceeds from both sales were credited to petitioner's account with Gruntal.

2.

On or about December 31, 1958, petitioner purchased from Royal State Bank of New York (hereinafter Royal State) $500,000.00 face amount U. S. Treasury Notes, 1½% due October 1, 1961. The purchase price was $475,937.50 plus accrued interest of $1,875.00 for a total of $477,812.50. Petitioner paid the purchase price by borrowing $480,000.00 from Royal State and executed a full recourse note due June 30, 1960, secured by a pledge of the Treasury Notes, with interest at 4% per annum. On or about December 30, 1958, petitioner paid, by certified check to Royal State the sum of $28,800.00 as interest in advance to the maturity of the note.

On or about June 9, 1960, petitioner sold the Treasury Notes for a price of $487,187.50 plus accrued interest in the amount of $1,434.43 for a total of $488,621.93. The proceeds were used to pay off the $480,000.00 loan from Royal State and the balance, together with a rebate of a portion of the interest, previously prepaid by petitioner, in the amount of $1,200.00, was remitted to petitioner.

At no time did any of the lenders or brokers involved in the foregoing transactions sell short the subject or equivalent securities as a means of financing the loan to petitioner; petitioner retained ownership of the Notes and Bonds for periods ranging from three months to 18 months; all transactions were affected at the prevailing market prices for the days involved; all transactions were executed upon the instructions of Bernard acting as agent for petitioner; and there were no prior arrangements or commitments of any kind by any party with respect to the ownership or disposition of the securities.

Petitioner, in the joint income tax return for 1958, deducted the interest paid to Jersey City Bank and Royal State in the amounts of $52,596.61 and $28,800.00 respectively, or a total of $81,396.61. All rebates of interest and gains on the sales of the securities were reported in the income tax returns of petitioner for the years in which realized.

Questions Presented

Is it proper to deny the deduction, under Section 163 of the Internal Revenue Code of 1954, of interest prepaid on loans obtained from banks to pay part of the purchase price of United States Treasury securities where the subject transactions are regular in every respect, but the tax-

payer's sole motive in entering into the transaction is presumed to be the avoidance of income tax.

Preliminary

These cases involve the deductibility of interest under Section 163 of the Internal Revenue Code of 1954 (hereinafter 1954 Code). In each of the cases, the petitioner placed orders with a broker to purchase U. S. Treasury Certificates. The orders were duly executed and in each case moneys were borrowed from a bank to pay part of the purchase price and interest was prepaid on the borrowing. The petitioners duly executed and delivered promissory notes for the amount of the loans to the respective lenders with full recourse. The interest was paid in cash. The hypothecated securities were retained by the lending banks until the taxpayers sold their securities and paid off their loans with the proceeds.

The three cases joined in this petition were heard together by the Court of Appeals. The principal decision was issued by the Court in the case of *Kapel Goldstein, et al.*, with subsidiary decisions in the other two cases, following *Goldstein,* and making certain further observations. The essential question in the three cases is the same, although the Court held the transactions in *Barnett* and in *Ippolito* were "sham", but not in *Goldstein.* In compliance with Rule 23, the three cases are consolidated in this one petition (separate appendices are provided), which is framed in terms of petitioner Goldstein alone in the interest of clarity. A brief addendum deals with the issue of "sham" in the other cases.

Petitioner's purchase of Treasury securities is no different in form or substance from thousands of such purchases made by taxpayers every day.

There was *no short sale* by anyone.[1] Petitioner's securities were pledged for purchase-money loans with two banks, as is the common every-day custom. The transactions were regular—ordinary.

In fact, the Second Circuit so found, rejecting the Tax Court's view that the transactions were "sham". Instead, it endorsed Judge Fay's dissenting view that the loan arrangements were "' . . . regular and, moreover, indistinguishable from any other legitimate loan transaction contracted for the purchase of government securities.' 44 T. C., at 301 . . . " (App., Goldstein, 70a).

The Second Circuit, nevertheless, disallowed the interest paid by petitioner on this wholly regular indebtedness as a deduction under Section 163. Postulating the existence of a "close question," the Court looked to the Congressional purpose underlying Section 163 and concluded that petitioner's interest payments, although entirely real—in no respect sham—were not deductible because her borrowings

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[1] In certain earlier cases, United States government obligations purchased and then pledged by taxpayers were sold short by the pledgees and the proceeds of such sales were advanced to the pledgors as "loans" with which to pay the obligations. Deduction of the interest paid on such "loans" by the pledgors has been denied in such cases. Cf. *Goodstein* v. *Com.*, C. A. 1, 1959, 267 F. 2d 127; *Lynch* v. *Com.*, 1960, C. A. 2, 273 F. 2d 86, aff'g 31 T. C. 990; *MacRae* v. *Com.*, 1961, C. A. 9, 294 F. 2d 56, aff'g 34 T. C. 20, cert. den., etc. As stated by the Tax Court in *MacRae, supra* (at p. 27), the short sale by the dealer neutralizes the original purchase by the taxpayer-pledgor. This is not such a case; the securities purchased by the petitioner in this case were pledged with a bank which retained the securities as collateral in the usual way throughout the duration of the loan.

were not "purposive." The deduction is allowable, the Court said, if the taxpayer's desire to receive an interest deduction is "only one of mixed motives" for the borrowing—if there is "some substance to the loan arrangement beyond the taxpayer's desire to secure the deduction" (App. 78a).

This is a new and far-reaching thesis, superimposed on the interest deduction after a half century of its application and interpretation. It is, we submit, ill-founded, resting on a series of invalid assumptions. It ignores time-tested precepts laid down by this Court. It is in hard conflict with the principle applied in parallel decisions by other Courts of Appeal. It advances an irrational and impractical test of mischievous potential for many investors and for the security markets, particularly the market for United States obligations. All of this is readily apparent.

The first false premise of the decision below is that a "close question" exists. As the Court conceded, petitioner's transactions were "regular" and "indistinguishable from any other legitimate loan transaction." Interest is deductible on "other" legitimate transactions and the statute provides no visible basis for differentiating one legitimate loan transaction from another.

The statutory language is clear and uncomplicated. But the court ignored its plain directive and obviously gave thought to the moral aspect—whether the statute *should* allow the deduction in view of petitioner's presumed motive. On that basis, the question may be close, but it is wholly irrelevant.[2] The taxpayer is entitled to the benefit of the statute as it is written.

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[2] Cf. *Maxwell Hardware Co.* v. *Com.*, 1965, C. A. 9, 343 F. 2d 713, 720, viz.: "Taxation is peculiarly a matter of statutory law,

No possible ambiguity appears in Section 163 to require an external search for its meaning. Long-standing precepts of this Court bar such a search where the meaning is plain.[3] Close analysis of the lower Court's unorthodox interpretation confirms the wisdom of those precepts. See *infra*.

A second false premise appears in the Court's statement of the Congressional purpose. "The underlying notion", as the Court puts it, of Section 163 is that, "if an individual or corporation desires to engage in purposive activity, there is no reason why a taxpayer who borrows for that purpose should fare worse . . . than one who finances the venture

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and in applying that law to the determination and computation of income and deductions, the Courts do not make moral judgments. . . . It is not a matter of conscience but of statute and the determination of Congressional intent."

[3] In *Old Colony Railroad Company* v. *Com.*, 1932, 284 U. S. 552, 52 S. Ct. 211, this Court held that in construing the phrase "interest . . . on its indebtedness" as used in section 234, 1921 Act (cognate to present section 163), "(T)he legislature must be presumed to use words in their known and ordinary signification, *Levy's Lessee* v. *M'Cartee*, 6 Pet. 102, 110 . . ." and this ". . . is always to be preferred to any curious, narrow, hidden sense that nothing but the exigencies of a hard case and the ingenuity and study of an acute and powerful intellect would discover, . . . *DeGanay* v. *Lederer*, 250 U. S. 376, 381." Similarly: *Deputy, et al.* v. *du Pont*, 1939, 308 U. S. 488, 60 S. Ct. 363. Cf. *Com.* v. *Clay B. Brown*, 1965, 380 U. S. 563, 85 S. Ct. 1162, where this Court recently said of the term "sale" as used in Section 117, 1939 I. R. C. (relating to capital gains and losses): "A 'sale', however, is a common event in the non-tax world; and since it is used in the Code without limiting definition and without legislative history indicating a contrary result, its common and ordinary meaning should at least be persuasive of its meaning as used in the Internal Revenue Code. Generally speaking, the language in the Revenue Act, just as in any statute, is to be given its ordinary meaning. . . . (cit.)."

It may be supposed that plain language in a statute serves as a beacon to the taxpayer which becomes a trap for the unwary if a hidden or twisted meaning is applied.

with capital that would otherwise have been yielding income" (App. 78a).

The flaw in the Court's statement is the proviso, i.e., that the interest deduction was intended to apply only if a taxpayer desires to engage in "purposive" activity. The Court offers no reference to any specific Committee Report or other authority for its statement. Others have stated the Congressional purpose differently.[4] The Court's statement begs the question, assuming what needs to be proved. What we are given, obviously, is the Court's conception of the "Congressional intent", tailored to fit its own moral view of what the statute *should* provide, rather than what Congress did, in fact, provide.

The thesis of the lower Court does not fit the statute as written, but rather, contradicts its plain and rational meaning. The Court has introduced "motive" as an element in Section 163, although the provision makes no mention of it and this Court has long taught that motive is irrelevant in applying a tax statute.[5] The test that the Court has interposed is essentially, "motive to make a profit." But "indebtedness" in Section 163 has always and necessarily encompassed personal borrowings. Can the single, indivisible word be rationally interpreted to require a

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[4] In *L. Lee Stanton*, 34 T. C. 1, at page 7, Judge Murdock wrote for the majority that, apart from the requirement that the transaction be real, "Congress has indicated that this deduction is not dependent in any other way upon the purpose or motive of the borrower or the use made of the borrowed money." Cf. Judge Fay's dissent in *Goldstein* to the effect that there is no legislative history indicating an intent that contradicts the plain meaning of Section 163 (App. 58a).

[5] Cf. *Gregory* v. *Helvering*, 1935, 293 U. S. 465, 55. S. Ct. 266. Where Congress has desired to impose a test relating to "motive", it has done so explicitly, as in the case of Section 269, relating to "acquisitions to evade or avoid income tax."

profit motive in some transactions, but not in others? To attribute such a schizophrenic intention to Congress surely demeans the legal process itself;[6] no less, an interpretation which validates personal borrowings to gamble, for example, or for a variety of other antisocial purposes—without semblance of restriction on motive—but would differentiate one legitimate loan to pay for United States securities from another on the basis of presumed motive.

Indeed, the conclusion of the Court below, that Congress did not intend to allow the interest deduction in a transaction motivated solely by tax avoidance is flatly contradicted by the legislative history of the statute.[7]

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[6] The Commissioner's own regulations provide categorically: "§1.163-1. Interest deduction in general. (a) Except as otherwise provided in sections 264 to 267, inclusive, interest paid or accrued within the taxble year on indebtedness shall be allowed as a deduction in computing income . . ." The present case does not fall within any of the express exceptions stated in Sections 264-267 of the Code. When, for example, Congress desired to limit the deduction for losses in respect to certain business, profit and personal classifications, it did so by explicit enumeration. Section 165, 1954 I. R. C.

[7] The legislative history of Section 23(b) (identical antecedent of present Section 163) is traced at length in the case of *L. Lee Stanton, supra*, at pp. 7-8. This shows that proposed amendments to the provision, designed to bar the interest deduction on "indebtedness incurred or continued for the purpose of evading the payment of taxes", were repeatedly stricken from proposed Revenue bills.

Whenever Congress desired to limit the allowance of a deduction for interest, it has repeatedly done so by specific legislation. It has done this over the years by denying a deduction for interest on indebtedness to purchase or carry tax exempt securities (Section 265(2)); by denying a deduction for interest on indebtedness to purchase single premium annuity contracts (subsequently further modified) (Section 264(a)(2)); by denying a deduction for interest on indebtedness incurred to purchase certain types of life insurance (Section 264(a)(2)), etc. It has denied a deduction for losses sustained in "wash sales" (Section 1091), etc. Instances of this sort are, of course, too common and numerous to be detailed in full here.

We submit that the principle of this case is clearly irrational; it may be expected to beget uncertainty and confusion in the administration of Section 163. It is, moreover, impractical and latently mischievous.

Given the condition that a taxpayer knows at the outset that any economic loss he may sustain on his investment will be offset by the deduction for interest paid, we submit that no one—no mortal, at least—may be reasonably sure what his true motive was in making the purchase, not even, perhaps, the individual himself. The certainty of redemption from loss is too strong an incentive for the ordinary human being to ignore. How is one to probe the innermost thoughts of each investor?

The case of *L. Lee Stanton, supra,* is significant on this. Stanton, a floor broker for an odd-lot house on the New York Stock Exchange, bought $5,000,000 face amount of U. S. Treasury 1½% Notes maturing in two years, for $4,921,968.75, plus accrued interest. He borrowed $5,000,000 from four banks at 3% interest, nearly twice his yield of 1.55%, to pay for the Notes. Stanton realized a pre-tax (economic) loss on the resale of the Notes, but a profit after deduction of the interest he paid on his loan.

The Tax Court held Stanton could properly deduct the interest paid on his loan.[8] Four judges dissented. While finding that Stanton had expected to realize a profit before taxes (at p. 4) and concluding that "it was a transaction entered into for profit" (at p. 8), the majority went to great lengths in tracing the legislative history of the interest deduction provision and analyzing its language, concluding:

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[8] See also *Hood* v. *Com'r* (1961), 20 T. C. M. 1140 and *Sadie S. Friedman* v. *Com.* (1960), 34 T. C. 456, remanded on another ground, C. A. 1, 1961, 294 F. 2d 876.

> "Congress has included no requirement in the Code that the borrowed money be used in connection with a transaction entered into for profit or that it cannot be borrowed for nonbusiness purposes or used in an action entered into for profit or that it cannot be borrowed for personal or nonbusiness purposes or used in a transaction involving tax benefits, cf. *Commissioner* v. *Park*, 113 F. 2d 352, and the Tax Court has no authority to read or write such requirements into the law."

In light of its finding that Stanton did in fact expect a pre-tax profit, the majority's painstaking analysis of the history and language of the statute and its positive conclusion that the deduction is not dependent on profit motive evidently reflect two facts: (1) The four dissenting Judges strongly questioned Stanton's true motive; one went so far as to suggest that Stanton had been motivated by Livingstone—the entrepeneur of the short-sale transactions at issue in *Goodstein* v. *Com., supra*, and a host of other cases (Pierce, J., at p. 17). (2) It strongly suggests that the majority, itself, was not entirely sure of Stanton's motive. That inference is strengthened by this further statement in the majority opinion:

> "The Internal Revenue Code imposed heavy taxes upon Lee and he sought a legal way within the provisions of the Code to make a profit for himself after taxes, the only kind of profit which can do any taxpayer any good" (at p. 8).

The impracticality of asking revenue agents to make a fair determination as to the true motive of a particular taxpayer in this situation is evident. Or is the Revenue

Service now to instruct its field agents to give wealthy brokers the benefit of the doubt, and to disallow the deduction automatically to all sweepstake winners? What about the ordinary investor? An odd lot floor broker like Mr. Stanton has no greater expertise in the Government securities area by reason of his calling than many an amateur or semi-professional investor with a bit of native acumen about money and a habit of reading the financial news.[9] There is the problem.

The ordinary investor who may feel there is a profit potential in a margin purchase of Treasury securities might well hesitate if he's prudent or well-advised, and ask himself: "Will they believe my motive was to make a profit? I can't risk losing the deduction for the interest I'll have to pay, since then I'll have a certain loss."

Multiply this by the hundreds, or thousands, and the rule applied here must, in due course, alter the breadth and liquidity of the market in government obligations.

It is not humanly practical to determine with any certainty what motivated a taxpayer in these transactions. The principle laid down by the Second Circuit defies reason, also, in supposing that tax motive may be the *sole* reason in any case. " . . . the interest deduction should be permitted," the Court wrote, "whenever it can be said that the taxpayer's desire to secure an interest deduction is only one of mixed motives that prompts the taxpayer to borrow funds" (App. 78a). Petitioner was denied her deduction on that premise. The fallacy of this is that, whatever the

[9] The function of an odd lot floor broker on the New York Stock Exchange is to buy and sell round lots of securities (multiples of 100 shares) as odd lot orders (under 100 shares) are received from member firms, in order to keep the securities position of his firm in the desired balance.

odds, the possibility of profit exists when obligations of the United States are bought, whatever the price. The securities have a free market that fluctuates with various influences, particularly the condition of the money market. It is unrealistic to suppose that one who buys these obligations with partly borrowed money simple exercises all hope and expectation of realizing the potential economic profit, apart from the interest deduction, from his mind and heart. If the possibility exists, the hope also exists. The hypothesis of the lower Court that there may be a pure tax motive in a case like this is fanciful.

There is thus presented here the question whether interest paid on a loan to pay for United States Treasury securities may be denied as a deduction where the taxpayer's motive in entering into the transaction is presumed to be solely to avoid income tax—although the transaction is in no way sham.

Petitioner submits that since no proper basis appears to differentiate between Section 163 and various other provisions of the Internal Revenue Code, the question really presented is whether any transaction may be disregarded for tax purposes where the sole motive may be presumed to be tax avoidance.

By granting certiorari in this case, this Court can clear away a great burden of uncertainty and confusion. The broad character of the principle announced and the fundamental ground of legislative purpose on which the decision purports to rest make it a potentially important precedent, not only for the interest deduction but for other areas as well. The uncertainty and confusion are likely to be aggra-

vated by the conflict that exists between the Second Circuit and two others as to the validity of the principle applied and, also, by the evident misapplication by the Second Circuit of this Court's decision in *Knetsch* v. *U. S.*, 1960, 364 U. S. 361, 81 S. Ct. 132. See *infra*.

Reasons for Granting the Writ

1. A conflict in controlling principle exists between this case and *Fabreeka Products Co., et al.* v. *Com.*, 1961, C. A. 1, 294 F. 2d 876. The facts of the two cases are not the same, but the conflict is, nevertheless, direct and outright, demonstrating the broad reach of the principle at issue.

In *Fabreeka Products*, the First Circuit held that a purchaser of securities is entitled to the tax benefits of Section 171 of the 1954 Code *even though it was properly found that the purchase was made solely to obtain the tax benefit.*[10] Section 171, as then constituted, gave a taxpayer who purchased callable bonds at a premium the right to amortize the premium to the earliest call date, whether the bonds were called or not.[11] The Fabreeka Company had purchased public utility bonds callable in 30 days at a premium, held the bonds for 30 days (they were not called), and then distributed them as a dividend to its shareholders. The recipients promptly sold the bonds for about the same premium as the Company had paid. The Commissioner opposed

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[10] Similarly: *Maysteel Products, Inc.* v. *Com.*, 1961, C. A. 7, 287 F. 2d 429, rev'g and rem'g 33 T. C. 1021.

[11] This was intended to compensate for that part of the coupon interest received which exceeded the actual yield of the bonds to the particular purchaser, reflecting the premium paid, which was taxed as ordinary income. H. Rept. No. 2333, 77th Cong., 2d Sess., at pp. 92-95; *Hanover Bank* v. *Com.*, 369 U. S. 672 (1962).

Fabreeka's deduction of the premium it had paid because the sole motive of the transaction was tax reduction.

While recognizing that the Commissioner's charge was "amply supported," the Court of Appeals nevertheless held the taxpayer's motive did not make its transaction sham. It said:

> "Unless Congress makes it abundantly clear, we do not think that tax consequences should be dependent upon the discovery of a purpose or state of mind, whether it be elaborate or simple. The limitation which the government asks us to read into the statute even if appealing in a particular instance, might readily, as we said in another connection in *Eaton* v. *White*, 1934, 70 F. 2d 449 at 452, 'create difficulties and uncertainties more objectionable in their results than any seeming inequities which would be eliminated or prevented'."

Section 163 and Section 171 are similar in design and purpose. Section 163 was designed to put borrowers on a par with those who use capital. Section 171 was enacted to put purchasers of non-exempt bonds on a par with purchasers of tax-exempt bonds, in respect of a premium paid; it permitted amortization of the premium in lieu of a capital loss. Thus, each provision was designed to cure an inequity.[12] Neither refers expressly to motive. Both cases were decided on the premise that the taxpayers purchased the bonds with no motive save tax avoidance. In *Fabreeka*, the First Circuit held the taxpayer's motive was immaterial; here, the Second Circuit made it the crux of the decision. The conflict is clear.

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[12] Amortized bond premium is a cost of carrying the bond similar to interest.

2. The conflict between the two circuits gains significance from another fact: Each Court offers as authority for its own contrary position the decision of this Court in *Knetsch, supra.* It thus appears in plain view that the lower courts are confused, and in disagreement, as to the true meaning of *Knetsch.* This case, we submit, reflects a plain misapplication of the doctrine of *Knetsch.*

In *Knetsch,* the taxpayer reborrowed all of his own payments on an ostensible $8,000,000 annuity, leaving a net cash value of about $1,000, and this Court concluded that, "Knetsch's transactions with the insurance company did not affect his beneficial interest except to reduce his tax." There was no substance to the claimed indebtedness. In this case, the petitioner borrowed money to pay for securities which she purchased and which she continued to own at all relevant times—an arrangement which the lower court itself deemed "indistinguishable from any other legitimate loan transaction." The lower Court has obviously misconceived the true meaning of *Knetsch* in this case.[13]

In *Knetsch,* also, this Court "put aside a finding . . . that Knetsch's only motive in purchasing [the annuity] was to attempt to secure an interest deduction." The Second Cir-

[13] In *Knetsch,* this Court adopted the test suggested by Judge Hand dissenting in *Gilbert, et al.* v. *Com.,* C. A. 2, 1957, 248 F. 2d 399, 410-411, i.e., that the transaction must appreciably affect the taxpayer's beneficial interest. It is clear that this Court held in *Knetsch* that the interest was not deductible because the transaction was essentially unreal and not because the taxpayer had sought to avoid the tax. Similarly, in his *Gilbert* dissent, Judge Hand stated that the taxpayer, "will also be relieved, if he supposes that the transaction will, or may cause him a loss, although in that event it is true that his only motive will be to avoid the tax." The decision of the Court below in this case is clearly contrary to the foregoing in principle.

cuit evidently interpreted this as leaving open for consideration the question of taxpayer's motive. The First Circuit clearly understood that *Knetsch* precludes consideration of the taxpayer's motive. The confrontation of the Circuits over the meaning of *Knetsch* is direct and bold. The significance of the issue as presented in this case, for the orderly administration of the revenue, for investors and for the government bond market, make it an appropriate medium for the clarification of *Knetsch*, as well as for the resolution of the conflict between the First and Second Circuits.

3. The full ramifications of the decision in this case are hard to measure, but they are necessarily broad. The identity of basic issue with *Fabreeka Products*, arising under a different Code provision, fairly attests this. Nothing in the terms or history of Section 163 makes the principle peculiar to the interest deduction. It is common, for example, for taxpayers to sell securities at a profit in order to offset prior capital losses which are non-beneficial, and then to repurchase the same securities after a short interval in order to continue the investment. Such a sale and purchase are clearly effected solely for tax purposes, yet have always been recognized as valid and effective.[14]

What if a corporation issues debentures as a dividend to its stockholder solely to obtain a deduction for interest thereafter paid on such debentures, in lieu of non-deductible dividends? That precise question was presented in

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[14] In respect to sales at a *loss*, Congress enacted the so-called "wash-sale" rule, barring deduction of the loss if substantially identical securities are acquired by the taxpayer within a period beginning 30 days before the date of sale and ending 30 days after such date. Section 1091, 1954 I. R. C.

Kraft Foods Co. v. *Com.*, 1956, 232 F. 2d 118. The Second Circuit there held that the debentures might not be disregarded for tax purposes, rejecting the Commissioner's complaint that the sole purpose of the transaction was to minimize taxes. The divergence of principle between that case and this one must certainly confound the application of Section 163 for taxpayer and Revenue Service alike. Which rule shall apply in future cases of variant facts but identical tax-saving issue?

The circumstances in which transactions may be carried out solely for tax purposes, or which are practical solely by reason of the tax consequences, appear highly diverse.[15] The importance of the issue herein cannot be exaggerated, generally, as well as for the interest deduction specifically.[16]

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[15] Cf. *Com.* v. *Clay B. Brown, supra,* in which this Court held that the sale of a business to a tax-exempt organization, to be paid for out of the income of the business within 10 years, provided a capital gain to the seller. As Mr. Justice Harlan, wrote in his concurring opinion, "were it not for the tax laws, the respondent's transaction with the Institute would make no sense, except as one arising from a charitable impulse."

[16] The importance of the issue is attested by published reports of the Federal Reserve Board, which show that in the month of April, 1966, alone, New York Stock Exchange member firms extended credit to customers, on securities pledged as collateral, in the total amount of $5,671,000,000. In the same month banks extended credit to customers (other than brokers and dealers) in the total of $2,283,000,000. Of these amounts, $26,000,000 and $105,000,000 in loans were made on the collateral of U. S. Government securities. During this same period, brokers and dealers borrowed $108,000,000 on the security of U. S. Government bonds. (Federal Reserve Bulletin, August 1966.) This does not take into account security loans extended by institutions other than Stock Exchange firms or banks. Moreover, the importance of the interest deduction generally is reflected in statistics released by the Treasury Department, showing that the deductions for interest claimed by all taxpayers on Federal income tax returns in 1963 amounted to $10,274,461,000, accounting for approximately 25% of all itemized

4. The status of the *Stanton* case is also in urgent need of clarification. The Second Circuit's opinion makes no reference to *Stanton*.[17] This, plus the equivocal character of the majority opinion in *Stanton* leaves the issue in a state of uncertainty. The implicit threat of the tax avoidance test advanced by the Second Circuit can only be expected to have a dampening effect on investing and trading in United States Treasury obligations—a matter of obvious importance to the Federal Government, as well as to investors generally and the securities business. This effect may be hard to measure, but investors and their advisers will be aware of the threat and may be expected to be wary of incurring an inevitable loss because of disallowance of the interest deduction. The uncertainty attending the issue is reflected in the fact that four separate opinions were written in the *Stanton* case. The impracticality of the principle adduced here and the burdens it imposes on the administration of the Revenue, with the attendant potential for discrimination, compound the need for clarification.

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deductions (Statistics of Income—1963; U. S. Treasury Department [publication No. 79 (1-66)]).

This Court has frequently granted certiorari on the basis that the cases represented important federal tax questions. Such cases include: *Crane* v. *Commissioner*, 1947, 331 U. S. 1, involving basis of property; *Libson Shops, Inc.* v. *Koehler*, 1957, 353 U. S. 382, involving the carryover of net operating losses; *P. G. Lake, Inc.* v. *Commissioner*, 1958, 356 U. S. 260, involving assignment of oil royalty payments; *Camnarano* v. *Commissioner*, 1959, 358 U. S. 498, involving deductions for amounts paid to influence legislation; *Rudolph* v. *U. S.*, 1962, 370 U. S. 269, involving definition of income and ordinary and necessary business expenses; *Meyer* v. *U. S.*, 1964, 375 U. S. 233, involving tax liens; *Lykes* v. *U. S.*, 1952, 343 U. S. 118, involving deductibility of legal expenses.

[17] The Commissioner filed an appeal in the *Stanton* case, but this was later withdrawn.

The Facts

(Max Barnett, et al. v. Commissioner)

Max Barnett (hereinafter Petitioner) in 1957 was the recipient of a $50,000 prize pursuant to a contest conducted by a New York newspaper. Petitioner filed a joint Federal income tax return with his wife for the year 1957, employing the cash receipts and disbursements method of accounting.

On or about December 20, 1957 petitioner purchased from the Gibraltar Financial Corporation (hereinafter GFC) $750,000 face amount of U. S. Treasury Certificates of Indebtedness, 3¾% due December 1, 1958 (hereinafter Treasury Certificates) at a price of 100.23 plus accrued interest for a total of $757,090.49. GFC was a dealer in Municipal, State and Federal bonds. Petitioner paid GFC $9,199.86 by check, as margin on the purchase of the Treasury Certificates.

Petitioner executed a note for $747,890.63 payable to GFC, dated December 23, 1957, for the balance of the purchase price, bearing interest at the rate of 5¾% per annum and due September 23, 1958. The note provided, among other things, that petitioner could prepay the principal of the loan at any time without penalty except that if prepaid within thirty days from the date of the note he would be liable for thirty days interest; and if the interest due on the note was prepaid, the interest rate would be reduced to 5½% or 5⅝% depending on when prepaid. On December 26, 1957 petitioner paid GFC $30,850.49 by check as interest in advance to the maturity of the note.

On December 20, 1957, GFC purchased $750,000 face amount of Treasury Certificates from The First Boston

Corporation, a well known dealer in government bonds. On December 23, 1957, GFC borrowed $740,000 at 4% interest from Cleveland Trust Company which it used to finance the $747,890.63 loan to petitioner.

Petitioner pledged the Treasury Certificates, which he had purchased, with GFC to collateralize his loan for $747,890.63 giving to GFC, among other things, the right to hypothecate and re-hypothecate those securities. GFC re-hypothecated the Treasury Certificates with Cleveland Trust to collateralize its $740,000 loan.

GFC did not sell these or equivalent Treasury Certificates "short". Chemical Bank, as the correspondent of Cleveland Trust, at all times during the term that the loan to GFC was in force, held the Treasury Certificates delivered by GFC (which were pledged by petitioner) in identical form as security for GFC's loan with Cleveland Trust. There were no arrangements between petitioner, GFC or anyone else concerning the continued ownership or disposition of the Treasury Certificates; and the ultimate disposition thereof was solely within the control of petitioner. All transactions were affected at the prevailing market prices for the days involved.

On January 2, 1958 petitioner sold to GFC $250,000 face value of the Treasury Certificates at a price of 100.25 plus accrued interest for a total of $252,803.06. The proceeds from such sale were used in part to reduce petitioner's loan with GFC, and the balance refunded to him. On January 3, 1958, GFC mailed its check to petitioner in the amount of $3,506.18 which represented his profit on the purchase and sale plus one third of the margin deposit originally put up by him.

On January 17, 1958, petitioner sold to GFC the remaining $500,000 face value Treasury Certificates at a price of 101 plus accrued interest for a total of $507,575.55. The proceeds from such sale were used in part to reduce petitioner's loan with GFC, and the balance refunded to him. On January 20, 1958 GFC mailed its check to petitioner in the amount of $8,981.80 which represented his profit on the purchase and sale plus the balance of the margin deposit originally put up by him.

Following the sales by petitioner and the repayment of his loan from GFC, petitioner received refunds of interest representing the unearned portion originally prepaid on December 26, 1957, as follows:

January 3, 1958	$ 9,140.89
January 20, 1958	18,282.17
	$27,423.06

Petitioner deducted in his 1957 joint Federal income tax return, interest in the amount of $30,850.49 representing the amount paid as interest to GFC on December 26, 1957. All rebates of interest and gain on the sale of the securities were reported in their 1958 joint Federal income tax return.

The Facts

(Michael J. Ippolito, et al. v. Commissioner)

Michael J. Ippolito (hereinafter petitioner) was found to be the holder of a winning ticket on the Irish Sweepstakes and, in 1955, collected $138,567.50. Petitioner filed a joint Federal income tax return with his wife for the year 1957, employing the cash receipts and disbursements method of accounting.

On or about December 23, 1955, petitioner, through his accountant, purchased from the Gibraltar Financial Corporation (hereinafter GFC) $1,000,000 face amount of U. S. Treasury Certificates of Indebtedness, 2⅝ percent due December 1, 1956 (hereinafter Treasury Certificates) at a price of 100.1 plus accrued interest for a total of $1,001,864.75. GFC was a dealer in Municipal, State and Federal bonds.

Petitioner executed a note, with recourse, dated December 27, 1955, for $1,000,000 payable to GFC for part of the purchase price, bearing interest at the rate of 4 percent per annum and due December 1, 1956. The note provided, among other things, that petitioner could prepay the principal sum of the loan at any time without penalty except that if prepayment occurred within 30 days from the date of the note, he would be liable for 30 days' interest.

Petitioner paid GFC $1,864.75 by check as margin on the purchase of the Treasury Certificates, and pledged the Treasury Certificates to collateralize his loan, giving to GFC the right to hypothecate and rehypothecate the securities. On or before December 27, 1955, petitioner paid GFC $37,777.77 by check as interest in advance on the note for

$1,000,000 to the maturity of the note; and on the same date paid GFC $2,500 by check as a loan placement fee.

On or about December 23, 1955, GFC purchased $1,000,000 face amount of Treasury Certificates from C. J. Devine & Co., a well-known dealer in Government bonds. On or about December 27, 1955, GFC borrowed from Cleveland Trust Company a total of $1,945,000 on a 3½ percent interest demand note pledging as collateral security therefor $2,000,000 face amount of Treasury Certificates. As part of such borrowing, GFC rehypothecated the $1,000,000 face amount of the Treasury Certificates previously pledged with it by petitioner to secure $965,000 of the aforesaid total loan of $1,945,000 [the portion of the loan obtained for petitioner's account].

On or about January 12, 1956, petitioner sold to GFC the $1,000,000 face amount of Treasury Certificates at a price of 100-3/64 for a total price of $1,000,468.75 plus accrued interest of $3,084.02.

On or about January 17, 1956, GFC mailed to petitioner its check in the amount of $3,240.27, representing the balance in petitioner's account after the sale of the securities.

On the same day GFC mailed its check in the amount of $34,444.47 to petitioner as a rebate of interest previously prepaid in accordance with the terms of the note.

Petitioner deducted, in his 1955 joint Federal income tax return, interest in the amount of $37,777.77, representing the amount paid as interest to GFC on December 27, 1955, together with the $2,500 loan placement fee. All rebates of interest and gains on the sales of the securities were reported in their 1956 joint income tax return.

GFC did not at any time sell short the same or equivalent securities as the Treasury certificates purchased by petitioner which are here in issue. Cleveland Trust Company, at all times here material held $1,000,000 of these Treasury certificates as collateral for its loan to GFC.

All transactions of the petitioner here at issue were effected at the market prices prevailing for the day of execution. Neither petitioner nor his accountant had any arrangements with GFC concerning the continued ownership or disposition of the treasury certificates (other than the usual protective provisions set forth in petitioner's note), and the ultimate disposition thereof was solely within the control of petitioner.

Ippolito and Barnett—The Issue of "Sham"

The fact differences between the cases of *Ippolito* and *Barnett* and that of *Goldstein* are: (1) the latter held the original Treasury Notes, which she had purchased, for approximately 12 months in one instance and 18 months in the second instance; Ippolito held his securities 25 days and Barnett for 12 to 30 days. (2) Goldstein obtained her loans directly from the banks concerned. Ippolito and Barnett obtained their loans from the broker who had purchased the securities; the broker rehypothecated the securities with the Cleveland Trust Company which retained them throughout the duration of the transactions at issue.

There was no short sale by anyone of the securities purchased by either Barnett or Ippolito, or of equivalent securities.

In *Barnett*, the Tax Court noted that the certificates were purchased in the name of the broker, GFC, and that

neither the broker nor Barnett had possession—the certificates were held by Chemical Corn Exchange Bank in New York, as correspondent for the lender bank, Cleveland Trust Co. The Court found that: "Petitioner did not have any control at any time over the $750,000.00 of certificates;" also, that petitioner failed to prove that the arrangements with GFC amounted to anything more than a "paper transaction" (App., Barnett, 22a-24a).

The Tax Court found, further, that the arrangements had no substance and bona fides apart from income tax purposes.

The Court of Appeals agreed with the last conclusion and said, "it follows from what we said in *Goldstein* that the Tax Court's disallowance of the deduction must be affirmed" (App., Barnett, 42a).

In *Ippolito,* where Judge Fay of the Tax Court had not made such a finding, the Court of Appeals nevertheless concluded that, "the facts the Tax Court did find fully warrant the same conclusion" (App., Ippolito, 14a).

It is thus clear that the Court of Appeals has applied the same principle in these cases as in *Goldstein.*

The Court of Appeals further concluded in the *Barnett* case that the nature of the arrangement between the taxpayer and his broker, plus the extremely short duration of the loan transaction, lead to the conclusion that "the purported loan transaction here was indeed without substance and was a 'sham' of the discredited *Goodstein* variety . . ." [18] (App., Barnett, 43a).

Petitioners submit that this conclusion is wholly without factual basis. The *Goodstein* case was one of those in

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[18] *Goodstein* v. *Com., supra,* referred to by the Court, should not be confused with the *Goldstein* case now before this Court.

which the pledgee-lender sold short the same securities as were pledged with it, borrowed the pledged securities to make delivery against its sale and advanced the proceeds to the pledgor; this advance was the loan at issue in *Goodstein* and like cases. The Courts took the position that the sale by the pledgee-lender could properly be attributed to the taxpayer-pledgor and the short sale by the pledgee thus nullified the investment by the taxpayer and there was no real indebtedness based on an hypothecated investment. See *MacRae* v. *Com., supra* at page 27.

The *fact* simply is that *there was no short sale by anyone* in the *Barnett* or *Ippolito* cases, any more than in *Goldstein*. Examination of the facts in either of these cases will show that the dealings between the taxpayers and the broker were no different from those in any other of the thousands of margin transactions that take place every single business day.

It is evident that the lower Courts have labelled the transactions in *Barnett* and *Ippolito* as "sham" not because of a lack of substance or reality in the purchase of the Treasury Certificates or of their hypothecation, but because of the tax avoidance motive of the transaction. This is made clear by this further statement in the Court of Appeals' opinion in *Barnett*:

> "This plan is similar to, but significantly more transparent than the plan devised by the taxpayer and her advisors in *Goldstein* v. *Commissioner*, —— F. 2d —— (2 Cir. 1966), also decided today."

Since the Court held that the transactions in *Goldstein* were real, not sham, it is clear that when it referred to the instant transactions as "more transparent" than *Gold-*

stein, it meant only that the tax saving purpose was more obvious—more readily visible to the naked eye. Petitioners agree that this is so; but it does not disqualify their transactions for the Section 163 deduction. As stated by the First Circuit Court in *Fabreeka Products, supra,* in a similar context:

> "But this describes neither a sham transaction, nor one unmarked by events or risks beyond the control of the taxpayer nor one different in substance and effect from what it appeared to be on its face. Cf. *Commissioner* v. *Tower,* 1945, 327 U. S. 280; *Johnson* v. *Commissioner,* 2nd Cir. 1936, 86 F. 2d 710; *Gregory* v. *Helvering,* 1935, 293 U. S. 465; *Knetsch* v. *United States,* 1960, 364 U. S. 361."

These petitioners kept their securities for less than a month. But there is no requirement in Section 163 as to the time that hypothecated securities must be held to qualify. Many margin securities transactions last no more than a day, yet the interest paid is allowable as a deduction, and it is regularly allowed. Facts cited by the Courts as indicative of "sham", such as that petitioners did not have possession of their securities (App., Barnett, 28a, Ippolito, 14a), merely describe the normal margin transaction.

These petitioners purchased their securities validly and obtained legal, enforceable bank loans through their broker to pay portions of the purchase price. They paid the interest in cash.

The lower Courts have manifestly equated tax avoidance motive with "sham" in these cases, contrary to law. Cf. *Fabreeka Products, Inc.* v. *Com., supra.*

The real issue in these cases is the same as in *Goldstein*: Whether petitioners' tax saving motive disqualifies the interest which they paid on their indebtedness as a deduction under Section 163. Certiorari should be granted in all three cases to determine that question in view of its importance and the conflict with the *Fabreeka* and *Maysteel* cases, *supra*, as well as the other grounds here advanced.

CONCLUSION

For the reasons set forth, it is respectfully urged that a writ of certiorari issue to the Court of Appeals for the Second Circuit in each of the cases herein joined.

Respectfully submitted,

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Supreme Court of the United States

OCTOBER TERM, 1966

No. 728

KAPEL GOLDSTEIN and TILLIE GOLDSTEIN,

Petitioners,

—against—

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

APPENDIX TO PETITION FOR A WRIT OF CERTIORARI

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Findings of Fact and Opinion of the Tax Court (Withdrawn)

The following case was withdrawn and vacated by official order of the Tax Court, dated 11/23/64.

Memorandum Findings of Fact and Opinion

Pierce, Judge: Respondent determined a deficiency in the income taxes of the petitioners for the calendar year 1958 in the amount of $55,193.34.

There is only one issue for decision: Are the petitioners entitled to an interest deduction of $81,396.61 under section 163(a) of the 1954 Code for the taxable year involved, representing amounts alleged to be prepaid interest which were paid to two banks in respect of alleged loans of money to petitioner Tillie Goldstein for the purchase of U. S. Treasury notes and bonds.

Findings of Fact

Some of the facts were stipulated. The stipulation of facts, together with the exhibits therein identified, is incorporated herein by reference.

Petitioners, Kapel and Tillie Goldstein, were during the taxable calendar year 1958 husband and wife, residing in Brooklyn, New York. They filed a joint Federal income tax return for said year, on the cash receipts and disbursements basis, with the district director of internal revenue at Brooklyn. The term "petitioner" as used herein, will have reference to Tillie Goldstein.

During the taxable year 1958, Kapel and Tillie Goldstein were an elderly retired couple in their seventies. Neither was engaged in any trade or business. As of December 1, 1958 (prior to receipt of a substantial sum as sweepstakes winnings—presently to be described), their assets consisted of the following:

Findings of Fact and Opinion of the Tax Court (Withdrawn)

Dry Dock Savings Bank	$ 1,350
First National City Bank	360
Dry Dock Savings Bank (second acct.)	700
Note receivable from Lou Katz	6,000
Loan receivable from Sidney Handsman	3,000
Funds on deposit, New York Life Insurance Company (matured endowment policy)	1,000
U. S. Government Series E Bonds	1,000
Cash surrender value of life insurance policies (estimated)	2,500
Total assets	$15,910

The record does not contain evidence of their liabilities (if any) at said date.

Apparently, their only sources of income at this time were a small pension of Kapel's (amounting to about $750 per year), and interest income of approximately $125 per year.

Fortune smiled broadly on Tillie Goldstein in 1958, for in that year she was found to be the holder of a winning ticket on the Irish Sweepstakes, as a result of which in December of said year she received $140,218.75, which she deposited in a bank account.

Petitioner and her husband had a son, Bernard, who practiced as a certified public accountant in New York City. In connection with his practice he advised his clients from time to time on financial matters, including giving advice with respect to the investment of their funds. Bernard undertook to advise petitioner with respect to the investment of the money which she had won; and in the transactions revolving around the purchase and sale of Government securities presently to be described, he acted as petitioner's agent.

Findings of Fact and Opinion of the Tax Court (Withdrawn)

In the summer of 1958, the market for bonds and notes issued by the Treasury of the United States had suffered its most severe decline in 20 years. This market decline was extensively publicized in business periodicals and in the financial sections of newspapers, which Bernard read in connection with the conduct of his accounting practice. By December 1958, the Government securities market had rallied slightly; and Bernard (along with certain Government economists and persons in the securities business) was hopeful and was of the belief that the market was on the way to a recovery that would take the prices of Government securities back to the high positions they had enjoyed earlier in the year.

The following table shows, as of December 24, 1958, price data with respect to Treasury 1½ percent notes (hereinafter called "Treasury 1½'s"):

Maturity date of Treasury 1½'s	Bid	Asked	Yield (%)	High for 1958	Low for 1958
Apr. 1, 1959	99.22	99.26	2.24	(not shown)	(not shown)
Oct. 1, 1959	99.2	99.8	2.51	100.23	98.4
Apr. 1, 1960	98.2	98.10	2.87	100.12	97.20
Oct. 1, 1960	97.4	97.12	3.04	100.4	96.14
Apr. 1, 1961	95.28	96.4	3.29	99.14	95.16
Oct. 1, 1961	94.24	95.0	3.42	99.2	94.0
Apr. 1, 1962	93.14	93.22	3.57	98.8	92.20
Oct. 1, 1962	92.12	92.20	3.61	97.24	91.16
Apr. 1, 1963	91.14	91.22	3.61	97.12	90.8
Oct. 1, 1963	90.14	90.22	3.65	91.28	89.10

Note: In the columns of the foregoing table headed "Bid," "Asked," "High for 1958," and "Low for 1958," the digits following the decimal point represent 32d's of a whole dollar rather than 100ths of a whole dollar. Whenever prices of Treasury bonds and notes are mentioned throughout the remainder of these findings, and in the opinion, the fractional part of a quoted price will be in terms of 32d's, viz., 99.24 would mean 99-24/32 rather than 99-24/100.

Findings of Fact and Opinion of the Tax Court (Withdrawn)

Beginning in November 1958 (at which time it was known that petitioner held a winning sweepstakes ticket, but prior to actual receipt of her winnings), Bernard held a series of conferences with an attorney of his acquaintance, looking to investment opportunities for petitioner's winnings and also to means of reducing the Federal income tax to be paid on those winnings. The upshot of these conferences was a plan whereby petitioner would borrow funds which would be used to purchase Treasury 1½'s; and whereby she would prepay the interest on the loans to their maturity, and deduct such interest on her income tax return for 1958 (in which return there would also be reported as income the $140,218.75 of her sweepstakes winnings). During 1958, petitioner paid Bernard and the attorney for their services the aggregate sum of $6,500, which she deducted on her return for said year as "legal and accounting fees."

On or about January 1, 1959, shortly after the presently to be described transactions were initiated, Bernard made a computation showing the amount of the sweepstakes winnings that would be retained by petitioner after payment of Federal and state income taxes, if the projected transactions were carried out and completed, and if the market for Government securities remained constant at the level it had reached at the end of 1958. This computation is as follows:

Findings of Fact and Opinion of the Tax Court (Withdrawn)

Estimated Calculation of Money Retained from Irish Sweepstakes

Income		Disbursements	
1958	$140,000.00	Fed. tax	$13,914.04
		State tax	8,807.66
		Charities	1,300.00
		Fees (incl. $3000 BG *)	6,500
		Tip—Katherine	1,000
		Prepaid interest	81,396.61
	$140,000.00		$112,918.31
Less disbursements	112,918.31		
	$ 27,081.69		
1959			
Interest collected	$ 15,000.00	State tax	None
Less Accrued Int. Paid	3,750.00	Federal tax	$ 1,700.00
	$ 11,250.00		
Less Federal tax	1,700.00		
	$ 9,550.00		
1960			
Interest 500 M 1 yr.	$ 7,500.00	State tax	None
Interest 500 M ½ yr.	3,750.00	Federal tax	$ 3,800.00
	$ 11,250.00		

Findings of Fact and Opinion of the Tax Court (Withdrawn)

Estimated Calculation of Money Retained from Irish Sweepstakes

Income		Disbursements	
Cap. Gain 1961-Bonds Estimated S. P.-98 6/32-Cost 95 6/32 Cap. Gain = 15,000	$ 15,000.00		
	$ 26,250.00		
Less Federal tax	3,800.00		
	$ 22,450.00		
1961			
Interest 500 M 9 mo.	$ 5,625.00	State tax	$ 150.00
Estimated Cap. Gain-S. P.-98 6/32-Cost = 92 30/32	26,250.00	Federal tax	3,600.00
	$ 31,875.00		$ 3,750.00
Less Fed. & State tax	3,750.00		
	$ 28,125.00		

Summary of Money Retained		Federal Taxes
1958	$27,081.69	$13,914.04
1959	9,550.00	1,700.00
1960	22,450.00	3,800.00
1961	28,125.00	3,600.00
	$87,206.69	$23,014.04
B. G.*	2,200.00	
	$89,406.69	

* The initials "B. G." appearing in the foregoing calculation refer to petitioner's son, Bernard Goldstein. The amounts appearing opposite said initials were paid to Bernard for services in carrying out the securities transaction.

Findings of Fact and Opinion of the Tax Court (Withdrawn)

Transactions with respect to Treasury 1½'s maturing October 1, 1962

Bernard, acting on behalf of petitioner, after approaching a bank and two brokerage houses, determined to deal with the firm of Garvin, Bantel & Co. in the purchase of these Treasury 1½'s. Garvin, Bantel is a member of the New York and American stock exchanges, with offices in New York City; and it is engaged in the business of buying and selling securities (including U. S. Government securities) for its clients. The firm also engages in the business of arranging collateral loans for its customers; and in this capacity, it is known as a "money broker."

Garvin, Bantel purchased $500,000 face amount of Treasury 1½'s maturing October 1, 1962, for petitioner from Malon S. Andrus, Inc. of New York City; and said Treasury notes were directed to be delivered by Andrus to the First National Bank of Jersey City (hereinafter called the "Jersey City bank") for petitioner's account. The purchase was confirmed by a confirmation slip from Andrus dated December 31, 1958, which stated that the price was 92.30, plus accrued interest of $1,875, or a total of $466,562.50, and that the Treasury notes would be delivered to the Jersey City bank. Garvin, Bantel received a commission of $156.25 from Andrus, for the former's services in connection with the purchase of the 1962 Treasury 1½'s.

Also, on December 31, 1958, petitioner borrowed from the Jersey City bank $465,000, to be used for the purchase of the 1962 Treasury 1½'s. The loan was evidenced by a promissory note signed by petitioner, with recourse, due on October 15, 1961, and bearing interest at the rate of 4 percent per annum, which was the prevailing rate at the time for loans of this character. Said promissory note

further recited that the maker had deposited with the Jersey City bank as collateral security "the following property owned by the undersigned [petitioner], viz: 500 M U. S. Treasury 1½% due 10-1-62." Typed on the promissory note was the statement: "Either party has the right to accelerate the maturity of this note after 30 days."

The loan was negotiated for petitioner by Garvin, Bantel, in its capacity of "money broker," acting pursuant to arrangements made with it by and on the initiative of Bernard as petitioner's agent. Garvin, Bantel received a commission from the Jersey City bank equal to ⅛ of 1 percent of the principal amount of the loan—the normal rate and practice in this type of transaction.

Petitioner instructed the Jersey City bank to receive from Andrus the Treasury 1½'s as collateral for the loan; and on January 16, 1959, the bank stated in a letter to petitioner:

> [W]e confirm that on December 30, 1958 500,000. U. S. Treasury 1½% Notes due October 1, 1962 were purchased from Malon S. Andrus, Inc. for your account. Said securities were delivered to us against payment of $466,562.50 on December 31, 1958.

Petitioner, on December 30, 1958, paid to the Jersey City bank, by means of a certified check drawn on the Irving Trust Company, the sum of $52,596.61, as interest on the above-mentioned $465,000 loan to the date of its maturity, October 15, 1961. Said check was delivered on behalf of petitioner to Garvin, Bantel for delivery to the Jersey City bank, and was received and deposited by the Jersey City bank on December 30, 1958.

The loan by the Jersey City bank to petitioner was made without anyone at the bank seeing or talking to petitioner

or Bernard, and without an investigation of the credit rating or financial standing of petitioner or of her husband. It is not the custom of the bank to make an investigation of the credit rating of the borrower in instances where large loans for the purchase of Government securities are placed with the bank by "money brokers"; and in such instances, the bank's practice is to address all communications respecting the loans to the broker, rather than to the borrower.

On April 22, 1959, the Jersey City bank wrote the following letter to Garvin, Bantel:

Re: Tillie Goldstein

Gentlemen:

At present, the subject owes us $465,000., on a loan arranged thru your office drawn to mature October 15, 1961. After reviewing our anticipated requirements for the immediate future, it has been deemed necessary to exercise the thirty day call privilege in connection with this loan to the extent of calling it for payment on June 20th next.

The calling of the loan by the Jersey City bank was not the result of any prearranged plan or scheme. At the time the loan was made, there were no agreements or commitments that the loan would be called on any certain date.

Garvin, Bantel advised petitioner of the Jersey City bank's decision to call the loan; and thereupon Bernard contacted Garvin, Bantel to see if the loan could be transferred to some other lending institution. An officer of Garvin, Bantel advised Bernard that he could arrange to transfer the loan to another brokerage firm in New York City, Gruntal & Co. Subsequently, on June 8, 1959, peti-

tioner was advised by a letter from Gruntal, that it would carry petitioner's $465,000 loan "at an interest rate of ¼% above money cost" to it. On the next day, June 9, the Jersey City bank delivered the 1962 Treasury 1½'s to Gruntal, against payment of the full amount of petitioner's $465,000 indebtedness to the Jersey City bank. The Jersey City bank delivered to Gruntal, together with the securities, a check for $42,944.61, for the account of petitioner, representing a rebate of the unearned portion of the prepaid interest. And on the same day, the Jersey City bank sent to Garvin, Bantel, petitioner's note, duly canceled and marked "paid." Petitioner did not receive this rebated interest, rather it was credited to her account and was subjected to monthly interest charges against petitioner by Gruntal.

The 1962 Treasury 1½'s received by Gruntal and held for petitioner's account were sold on December 1, 1959, for a price of 91.26, plus accrued interest of $1,270.49, less commission of $78.13, or a net total of $460,254.86, which was credited to petitioner's account with Gruntal. Petitioner sustained a loss on this transaction of $[illegible]703.13. Concurrently with the sale of the Treasury 1½'s, petitioner purchased through Gruntal $500,000 face amount of Treasury 2½% Bonds, due November 15, 1961 (hereinafter called "1961 Treasury Bonds"). This purchase was confirmed by Gruntal in a confirmation slip dated December 1, 1959, which stated that the purchase price was 95.13 plus accrued interest of $583.79, or a total of $477,693.17 which amount was charged to petitioner's account on December 1. Bernard ordered this substitution of 1961 Treasury Bonds for the 1962 Treasury 1½'s, for the reason that the former had a higher yield than the latter, and also an earlier maturity.

Findings of Fact and Opinion of the Tax Court (Withdrawn)

Thereafter, on February 4, 1960, petitioner sold $250,000 of the 1961 Treasury Bonds, at 96.17 plus accrued interest of $1,407.97, less commission of $78.13—or a total of $242,657.97, which Gruntal credited to petitioner's account. And subsequently on June 13, 1960, petitioner sold the remaining $250,000 of 1961 Treasury Bonds at 98.26 plus accrued interest of $509.51, less commission of $156.25—or a net total selling price of $247,384.51 which likewise was credited to petitioner's account. Petitioner realized an aggregate gain of $10,431.85 in the sales of the 1961 Treasury Bonds. Petitioner's account with Gruntal was closed out on June 25, 1960.

Transactions with Respect to Treasury 1½'s Maturing October 1, 1961

As an integral part of Bernard's plan for investing petitioner's winnings and achieving an interest deduction for Federal income tax purposes, a second transaction was initiated at the same time that the above-described transaction respecting the 1962 Treasury 1½'s were begun. This second transaction involved the purchase of $500,000 face amount of Treasury 1½% notes, maturing October 1, 1961 (hereinafter called 1961 Treasury 1½'s, and not to be confused with the above-mentioned Treasury 2½% *Bonds*, maturing November 15, 1961).

Bernard dealt directly with the Royal State Bank of New York City through its president, Henry Barber, in this second transaction. Pursuant to arrangements made between Bernard and Barber, the Royal State Bank on December 31, 1958, purchased for petitioner's account $500,000 face amount of 1961 Treasury 1½'s from the brokerage house of C. J. Devine & Co., in New York City. These

bonds were purchased at 95.6, plus accrued interest of $1,875, or a total of $477,812.50, which amount was charged by the bank to petitioner's account.

Also on December 31, 1958, petitioner borrowed from the Royal State Bank $480,000. This amount was credited to her account, and concurrently set up on the Royal State Bank's books as a collateralized loan. The loan was evidenced by petitioner's promissory note dated December 31, 1958, with recourse, in the amount of $480,000, "at the legal rate," and due 18 months after date, or on June 30, 1960. The rate of interest actually charged at the time this note was issued was 4 percent per annum, the going rate on loans of this type at the time. Said note further recited that the maker (petitioner) had therewith "pledged, assigned and transferred to" and "deposited with" the Royal State Bank "as collateral security for the payment of any and all liabilities and obligations of the undersigned to the Bank," including "this note and any renewals, modifications or extensions thereof," the following property: "$500,000 U. S. Treasury 1½% 10/1/61."

Petitioner paid by means of a certified check drawn on the Irving Trust Company dated December 30, 1958, to the Royal State Bank, $28,800, as interest at 4 percent per annum on her note of $480,000 until its maturity on June 30, 1960. The check was delivered to the Royal State Bank on behalf of petitioner, and was received and deposited by said bank on December 31, 1958.

Also on December 31, 1958, the Royal State Bank wrote the following letter to petitioner:

> This will acknowledge receipt of your certified check on the Irving Trust Co. in the amount of $28,800.00, representing payment to the Royal State Bank of New

Findings of Fact and Opinion of the Tax Court (Withdrawn)

York of interest for 18 months at 4% on your collateral note of $480,000.

We are also enclosing statement showing the purchase of $500,000 U. S. Treasury Notes, 1½%, due October 1, 1961, for which we charged your account today $477,812.50.

We are also enclosing copy of credit advice of your note of $480,000.

About 5 months later, on June 3, 1959, the Royal State Bank sent a letter to petitioner, which read as follows:

In view of the continued depreciation in the Government Bond market, which has reduced the value of your collateral, and the rise in the interest rate, we herewith request that you either liquidate your loan at the bank or pay us an additional sum of $2,600 which represents interest of ½ of 1% per annum on your note of $480,000 for the period of June 1, 1959 to June 30, 1960.

Please advise immediately whether you will liquidate this loan or pay the additional interest charge.

Following a conference between Bernard and Barber (president of the Royal State Bank) wherein it was learned that if petitioner desired to continue the loan, she had the option of furnishing additional collateral or of paying the additional interest mentioned in the above letter, Bernard decided that petitioner should take the latter course. Petitioner thereupon on June 8, 1959, sent a check to the Royal State Bank in the amount of $2,600, the additional interest required by said bank.

Thereafter in September 1959 the Royal State Bank contacted the attorney who was advising petitioner and Bernard, regarding the loan and the collateral therefor. In ac-

cordance with arrangements made between the bank and the attorney, Bernard sent to the bank as additional collateral for the loan, a passbook belonging to petitioner evidencing an account she then had with a savings and loan association, having a balance at that time of $4,500, together with an instrument of assignment relating to the passbook.

Pursuant to Bernard's instructions, the 1961 Treasury 1½'s held for petitioner's account by the Royal State Bank were sold on June 9, 1960, at 97.14 plus accrued interest of $1,434.43, or a total of $488,621.93. Petitioner realized a gain of $11,250, on this sale of 1961 Treasury 1½'s. The proceeds to the extent of $480,000 were used to pay petitioner's note to the bank, and the remaining $8,621.93 was credited to her account, which was in due course paid to petitioner. The bank also sent petitioner $1,200, as a rebate of unearned interest on the loan.

Both the 1961 and 1962 Treasury 1½'s and the 1961 Treasury bonds were purchased by petitioner with all future interest coupons attached thereto. After the notes and bonds were purchased by petitioner, and throughout the periods of time when the same were owned by her, the banks and the brokerage house (Jersey City bank, Royal State Bank and Gruntal & Co.) which held such securities as collateral, transmitted the interest income thereon to her; and she reported the same on her Federal income tax returns. Petitioner likewise reported on her 1959 return the loss sustained on her sale of 1962 Treasury 1½'s; and she also reported the gains realized on her sales of Government securities on her 1960 return.

Petitioner was free to sell the Government securities involved herein, at whatever market price that might prevail

at the time of sale. Petitioner had no arrangement, contractual or otherwise, under which she was either obligated or entitled to sell these securities to either of the banks or the brokerage houses with which she had been dealing, or to the Government bond dealers from whom such notes and bonds had been purchased, or to any other person. Nor was there any arrangement between petitioner and the just-mentioned parties, under which petitioner would be guaranteed a profit, or a loss on the said notes and bonds.

At least as far as the two banks with which petitioner dealt in the instant case are concerned, in instances where they lend funds to a borrower for the purpose of permitting the borrower to purchase Government bonds, the banks require they have control of the collateral at all times while the loan is outstanding. The securities are delivered directly to the bank; and it is not unusual for the borrower not to see the securities. Such securities might never come into the physical possession of the borrower; and the same is true where stocks are purchased from a broker on a margin account. Also, where a person borrows funds for the purpose of purchasing securities, he is able to secure a lower rate of interest if he prepays the interest on his loan obligation.

The following tabulation shows the projected economic results to petitioner at the time the above-described Treasury note transactions were entered into, if petitioner had carried out said transactions according to the plan developed by Bernard and the attorney with whom he had conferred, and if the Government securities market remained constant at the level it had reached in December, 1958:

Findings of Fact and Opinion of the Tax Court (Withdrawn)

Petitioner's outlay of funds:			
Interest prepaid to Jersey City bank			$52,596.61
Accrued interest on 1962 Treasury 1½'s			1,875.00
Interest prepaid to Royal State Bank			28,800.00
Accrued interest on 1961 Treasury 1½'s			1,875.00
Fees to Bernard and attorney			6,500.00
Total outlay of funds			$91,646.61
Petitioner's anticipated income Jersey City bank transactions:			
Interest income:			
April 1, 1959	$ 3,750.00		
Oct. 1, 1959	3,750.00		
April 1, 1960	3,750.00		
Oct. 1, 1960	3,750.00		
April 1, 1961	3,750.00		
Oct. 1, 1961	3,750.00		
Oct. 15, 1961	312.50		
Total		$22,812.50	
Capital gain on sale:			
Proceeds of sale at 99.2	$495,312.50		
Less cost	464,687.50		
Gain		$30,625.00	
Total interest and gain on Jersey City transactions			$53,437.50
Royal State Bank transactions:			
Interest income:			
April 1, 1959	$3,750.00		
Oct. 1, 1959	3,750.00		
April 1, 1960	3,750.00		
June 30, 1960	1,875.00		
Total		$13,125.00	
Capital gain:			
Proceeds of sale at 98.2	$490,312.50		
Cost	475,937.50		
Gain		$14,375.00	
Total interest and gain Royal State			$27,500.00
Aggregate interest and gain:			
Jersey City and Royal State transactions			$80,937.50
Less estimated Federal income tax on capital gains (45,000 at 25%)			11,250.00
Net proceeds to petitioner from Royal State and Jersey City transactions			$69,687.50
Net economic loss			$21,959.11

Findings of Fact and Opinion of the Tax Court (Withdrawn)

The following tabulation shows the projected economic results to petitioner if the Treasury note transactions had been carried out according to plan, and if the Government securities market had reached the same high positions which it had reached in 1958, at the times when petitioner would sell said notes:

Petitioner's outlay of funds (see preceding tabulation)		$91,646.61
Petitioner's anticipated income Jersey City bank transaction:		
Interest income (see preceding tabulation)	$22,812.50	
Capital Gain:		
Proceeds of sale at 100.23	$503,593.75	
Less: Cost	464,687.50	
Gain	38,906.25	
Total interest and gain—Jersey City		$61,718.75
Royal State Bank transaction:		
Interest income (see preceding tabulation)	$13,125.00	
Capital gain:		
Proceeds of sale at 100.12	$500,875.00	
Less: Cost	475,937.50	
Gain	$24,938.50	
Total interest and gain Royal State	38,163.50	
Aggregate interest and gain—Jersey City and Royal State		$99,882.25
Less: Estimated Federal income tax on capital gain (63,844.75 at 25%)		15,961.19
Net proceeds to petitioner from Jersey City and Royal State transactions		$83,921.06
Petitioner's net economic loss		$ 7,725.55

In 1961, after the transactions in Treasury notes and bonds which are here involved had been completed, petitioner deposited some of her sweepstakes winnings in savings and loan associations; and she invested the remainder in high-grade securities such as the shares of the Atchison, Topeka and Santa Fe Railroad, Bethlehem Steel Corporation, and Socony Mobil Corporation.

Findings of Fact and Opinion of the Tax Court (Withdrawn)

Set forth below is a summary of the receipts and expenditures *actually* made by petitioner in connection with her several transactions in Government securities, as described hereinabove:

Transactions with Jersey City Bank			
Prepaid interest	$52,596.81		
Less: Unearned interest transferred to Gruntal & Co.	42,944.61		
Net interest outlay		$ 9,652.20	
Interest Income:			
May 1959 payment	$ 3,750.00		
Less: accrued interest at time of purchase	1,875.00	1,875.00	
Excess of interest outlay over interest income (loss)			($ 7,777.20)
Transactions with Gruntal & Co.			
Total interest payments with respect to 1962 Treasury 1½'s and 1961 Treasury Bonds		$17,382.61	
Less: Net interest on bonds and notes		9,479.18	
Excess of interest outlay on interest income		$ 7,903.43	
Add: Loss on sale of 1962 Treasury 1½'s		5,625.00	
		$13,528.43	
Less: Gains on sales of 1961 Treasury Bonds		11,328.13	
Net excess of interest outlays over interest income and gains (loss)			($ 2,200.30)
Transactions with Royal State Bank			
Net total interest prepayments		$30,200.00	
Less: Interest income received		12,684.43	
Excess of interest outlay over interest income		$17,515.57	
Less: Gain on sale of 1961 Treasury 1½'s		11,250.00	
Net excess of interest outlays over interest income and gains (loss)			($ 6,265.57)
Recapitulation:			
Loss on Jersey City Bank transactions			$ 7,777.20
Loss on Gruntal & Co. transaction			2,200.30
Loss on Royal State Bank transactions			6,265.37
Total loss			$16,242.87

Findings of Fact and Opinion of the Tax Court (Withdrawn)

On her 1958 income tax return, petitioner claimed a deduction for interest paid in that year in the aggregate amount of $81,396.61, made up of $52,596.61 paid to the Jersey City bank and $28,800 paid to the Royal State Bank.

If petitioner had carried out the transactions in Treasury notes as planned by Bernard, her sweepstakes winnings would have been burdened with an aggregate tax liability of $23,014.04 according to estimates made by Bernard at the time such transactions were initiated. Petitioner's tax liability on such winnings as determined by respondent after disallowance of the claimed deductions for prepaid interest, was $69,637.38.

In his statutory notice of deficiency herein, the respondent disallowed the claimed interest deduction; and he explained his action as follows:

> The deduction claimed for alleged interest expense in the amount of $81,396.61 for the taxable year 1958 is disallowed for the reasons that the transactions involved were devoid of profit motive that the transactions were entered in merely to reduce your federal income taxes, that the transactions constitute a sham consisting of form without substance, and that the $81,396.61 does not constitute a payment of interest on indebtedness within the purview of section 163(a) of the Internal Revenue Code of 1954.

OPINION

The issue here presented for decision is, whether petitioner Tillie Goldstein, a cash basis taxpayer, is entitled to a deduction for the amounts which she paid, as prepaid

interest, on two promissory notes which she executed in connection with loans of funds from banks, which she used to purchase securities issued by the United States Treasury Department.

Petitioner seeks warrant for the deduction in section 163(a) of the 1954 Code, which provides as follows:

> SEC. 163. INTEREST.
>
> (a) General Rule.—There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

There can be no question that the amounts in question were actually paid, as interest, by petitioner. If these amounts are held by us to be deductible under the statute, then petitioner would be entitled to deduct the full amounts paid, notwithstanding that the notes were executed at the very end of the taxable year 1958 here involved and that the amounts paid actually represented prepayments for periods extending into succeeding years. The rule is well established that prepaid interest is deductible by a cash basis taxpayer in the year in which payment is made, even though it covers a period or periods extending beyond the current year of payment. *John D. Fackler* [Dec. 10,596], 39 B. T. A. 395, 398, acq. 1939-1 *C. B.* (Part I) 11, *I. T.* 3740, 1945 *C. B.* 109. The rule appears to be contra where the amount prepaid is for insurance (*Commissioner* v. *Boylston Marketing Association* (C. A. 1) [42-2 USTC ¶ 9820], 131 F. 2d 966, affirming a Memorandum Opinion of this Court [Dec. 12,169-B]; *Martha R. Peters* [Dec. 14,512], 4 T. C. 1236; but see *Waldheim Realty & Investment Co.* v. *Com-*

missioner (C. A. 8) [57-2 USTC ¶ 9717], 245 F. 2d 823, reversing [Dec. 21,617] 25 T. C. 1216), or for rent (*Main & McKinney Bldg. Co.* v. *Commissioner* (C. A. 5) [40-2 USTC ¶ 9558], 113 F. 2d 81, affirming a Memorandum Opinion of this Court [Dec. 10,808-6]; *Galatoire Bros.* v. *Lines* (C. A. 5) [1 USTC ¶ 275], 11 F. 2d 878; and *Baton Coal Co.* [Dec. 5882], 19 B. T. A. 169, affd. (C. A. 3) [2 USTC ¶ 788] 51 F. 2d 469, certiorari denied 284 U. S. 674). The courts, in the above cases, have held that where a cash basis taxpayer prepays rent or insurance, he must prorate deductions with respect to such prepayment, over the future period or periods benefited by such prepayment. The rule thus applicable to prepaid rent and insurance seems to be based on much more persuasive logic than that with respect to prepaid interest; and if the matter of the year for a cash basis taxpayer to deduct prepaid interest were before us now for the first time, we would be disposed to require proration of deductions for prepaid interest over all the periods benefited. However, the rule allowing full deduction in the year of payment of prepaid interest having become rather firmly imbedded, we may assume for present purposes that it will continue to be adhered to.

It needs to be said here and now that this case does not involve a Livingstone-inspired deal (see *Eli D. Goodstein* [Dec. 23,152], 30 T. C. 1178, affd. (C. A. 1) [59-1 USTC ¶ 9474] 267 F. 2d 127); that it does not involve a mere shuffling of papers or making of bookkeeping entries; and that—in short—it does not involve a lot of "hocus-pocus." There is not a shred of doubt in our mind that Tillie Goldstein borrowed $945,000 which she used to purchase obliga-

tions of the Treasury of the United States—that she owned and used as collateral security for the repayment of her borrowings, with respect to which she received and reported thousands of dollars of taxable income, and with respect to which she suffered losses and realized gains (likewise recognized on her tax returns) at the times these obligations were disposed of by her. And we repeat what we said above, that petitioner actually paid, as interest and with respect to the very borrowings which we have just mentioned, over $81,000, with no strings attached to retrieve it. Having said this much, we add that the *Goodstein* case and all of its numerous progeny of "Livingstone cases," have nothing to do with the case at bar; and if the Government means to place any reliance thereon in this case, such reliance is misplaced.

Notwithstanding that taxpayers may engage in "uneconomical" or "commercially unreal" transactions such as selling securities at a known and calculated loss, as a means of offsetting capital gains, and that such losses are recognized by the taxing authorities—the teaching of the Supreme Court of the United States is that interest must be paid in a transaction where some economic benefit is calculated to inure to the taxpayer other than reducing his taxes, if he is to be allowed the deduction granted by the statute for the interest paid. *Knetsch* v. *United States* [60-2 USTC ¶ 9785], 364 U. S. 361. See also the dissenting opinions in *L. Lee Stanton* [Dec. 24,122], 34 T. C. 1. We put the matter thusly in the recent case of *Joseph H. Bridg s* [Dec. 26,032], 39 T. C. 1064, 1075, affd. (C. A. 4)

[64-1 USTC ¶ 9103] 325 F. 2d 180, where we applied the *Knetsch* case:

> "[I]nterest" as used in the statute has a commercial connotation, that is, regardless of the purpose for which the money is borrowed, or the use to which it is put, and regardless of any tax consequences resulting therefrom, the amounts paid as interest must have commercial reality, there must be some valid commercial reason for paying interest, the borrower must in fact receive something in the transaction itself which would warrant the payment of interest. * * *

We look then to see if petitioner's transactions had commercial reality, *i.e.*, whether there was any valid commercial reason for her paying the interest here involved. Looking to the computations which we have made on the basis of the evidence in the present case, the transactions here involved were bound to result in an economic loss to petitioner, irrespective of whether the Government securities market remained constant at its December 1958 level, or whether it regained the 1958 high position, at the times when petitioner was scheduled to dispose of her Treasury obligations. And as our Findings of Fact plainly show, petitioner did in fact lose $16,242.87 on her Government securities transactions, as they were actually carried out. In the ordinary business affairs of men, we do not think that they borrow money in order to make investments on which an economic loss is anticipated. Borrowing in such circumstances would be both uneconomical and commercially unreal. We think that the real motivating purpose of the transactions here involved, was to attempt to reduce peti-

tioner's income tax liabilities on her sweepstakes winnings.[1] And, if the claimed deductions were allowable, she would have saved approximately $46,000 in taxes—more than enough to offset the economic loss resulting from the transactions themselves. But the teaching of the Supreme Court in *Knetsch* and of this Court in *Bridges*, is that where tax reduction is the only economic benefit flowing from the payment of interest on borrowed funds, then income tax deductions are not to be allowed in respect of such interest.

We decide the case for the respondent.

Decision will be entered for the respondent.

[1] We cannot help noting how petitioner's investment practices were changed, after the Government securities transactions were closed out, and the interest deductions had all been taken. At that time, petitioner's funds were put directly into such safe and conventional investments as savings and loan associations and the shares of large corporate enterprises, such as Bethlehem Steel Corporation, on which regular income for her latter years could be anticipated.

Findings of Fact and Opinion of The Tax Court

TAX COURT OF THE UNITED STATES

44 T. C. No. 29

Docket No. 94448

Filed May 28, 1965

KAPEL GOLDSTEIN and TILLIE GOLDSTEIN,

Petitioners,

—v.—

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Held, that sums which petitioner Tillie Goldstein paid, purportedly as "prepaid interest" on two newly created items of "indebtedness," did not in substance and reality constitute "interest * * * on indebtedness," within the intendment of section 163 (a), I. R. C. 1954; and accordingly said sums are not deductible.

I. Meyer Pincus, for the petitioners.

John E. McDermott, Jr., and *Donald H. Cuozzo,* for the respondent.

PIERCE, *Judge*: On October 20, 1964, this Court filed in this case Memorandum Findings of Fact and Opinion, and also entered a Decision in accordance therewith.

Thereafter on November 19, 1964, the petitioners filed herein, motions for reconsideration of said Memorandum

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Findings of Fact and Opinion, and also for revision of said Decision. The Court, upon consideration thereof, entered an Order herein on November 23, 1964, wherein it was ordered: (1) That the said Decision entered in this case on October 20, 1964, be, and the same was, withdrawn and vacated; (2) that petitioners' motion for reconsideration of the Memorandum Findings of Fact and Opinion issued under date of October 20, 1964, be, and the same was granted; and (3) that said Memorandum Findings of Fact and Opinion be, and the same was, withdrawn for reconsideration of the case.

The following are now the Findings of Fact and Opinion of the Court in this case.

The Commissioner determined a deficiency in the income tax of the petitioners for their taxable calendar year 1958, in the amount of $55,193.34.

The sole issue for decision is whether the sums of $52,596.61 and $28,800 (totaling $81,396.61), which petitioner Tillie Goldstein paid to certain lending institutions on December 31, 1958, and which she claims to be deductible for income tax purposes entirely in that year, as "prepaid interest" on two newly created items of "indebtedness" in the respective amounts of $465,000 and $480,000 (totaling

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$945,000), actually did, in substance and reality, constitute payments of "interest * * * on indebtedness" within the intendment of section 163 (a) of the Internal Revenue Code of 1954.

Findings of Fact and Opinion of the Tax Court

FINDINGS OF FACT

Some of the facts have been stipulated. The stipulation of facts and all exhibits identified therein are incorporated herein by reference; subject however to an understanding that descriptive words used therein, such as "promissory note," "interest," "sales," and "loans," are not conclusive as to the true character of the transactions to which they relate, or as to the actual existence of an "indebtedness" within the meaning of the applicable statute.

General Background Facts

The petitioners, Kapel Goldstein and Tillie Goldstein, are husband and wife who, during the taxable year here involved, resided in Brooklyn, New York. For said taxable year, they filed a joint Federal income tax return, on the cash receipts and disbursements basis, with the district director of internal revenue at Brooklyn. The issue presented concerns only the wife, Tillie Goldstein, whom we will hereafter refer to as "Tillie."

During the taxable year 1958, Tillie was a housewife; she was approximately 70 years of age. Her husband, Kapel, with whom she lived was a retired garment worker who

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received a pension of $780 per year. The couple's only income for the taxable year, exclusive of the proceeds from a winning Irish Sweepstakes ticket hereinafter mentioned, consisted of said $780 pension of the husband plus interest income of $124.45 from savings bank accounts. Also as of December 1, 1958 (which was prior to the receipt of said sweepstakes winning), the total assets of said couple consisted of the following:

Two accounts at Dry Dock Savings Bank	$ 2,050
Account at First National City Bank	360
Note receivable from Lou Katz	6,000
Loan receivable from Sidney Handsman	3,000
Funds on deposit, New York Life Insurance Company (matured endowment policy)	1,000
U. S. Government Series E Bonds	1,000
Cash surrender value of life insurance policies (estimated)	2,500
Total Assets	$15,910

The record does not disclose the amount of their liabilities, if any; nor does it disclose what portion, if any, of the above assets belonged to Tillie.

During the latter part of said year 1958, fortune smiled broadly on Tillie, for she learned that a ticket which she held on the Irish Sweepstakes was a winner; and that she would soon receive therefrom the sum of $140,218.75. Thereafter in December of said year, she did receive this amount. She deposited the same in a New York bank; and thereafter she included the same in gross income, in the above-mentioned income tax return which she and her husband filed for the year 1958.

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Tillie and her husband were the parents of a son, Bernard Goldstein, who in 1958 was a certified public accountant practicing in New York City. Beginning in November 1958, Bernard began a series of consultations with the attorney representing petitioners in the instant case—at least one phase of which consultations was the tax consequences

to Tillie of her sweepstakes winnings. The question of using the provisions of the Internal Revenue Code allowing deductions for interest paid on indebtedness, came up. Bernard wanted to use that section (section 163 of the 1954 Code), to save his mother taxes.

As a result of the foregoing discussions with the attorney, Bernard formulated and carried out a plan involving the use of the interest expense deduction provisions of the 1954 Code, which he calculated would result in total Federal income taxes of $23,014.04 on his mother's sweepstakes winnings, as opposed to the tax of about $69,600 on such winnings which was determined in the deficiency notice herein after disallowance of the claimed deduction for interest. Bernard's plan envisioned, in substance, the "purchase" by his mother Tillie of $1,000,000 face amount of U. S. Treasury 1½% notes, with "borrowed" funds on which she would prepay 4 percent "interest" for 1½ to 2½ years in the approximate amount of $80,000; and then the deduction by Tillie of such "interest" in its entirety, on the same 1958 income tax return on which her sweepstakes winnings of approximately $140,000 would be re-

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ported as income. The plan which was thereafter carried out, actually involved two separate transactions for the purported purchase of United States Treasury notes: One involving Treasury 1½% notes, maturing on October 1, 1962; and the other involving Treasury 1½% notes, maturing on October 1, 1961. The facts regarding these two transactions are as follows.

Findings of Fact and Opinion of the Tax Court

Facts re Transactions Involving Treasury 1½%
Notes Maturing October 1, 1962

In late December 1958, Bernard acting on behalf of his mother Tillie, had consultations with the New York investment firm of Garvin, Bantel & Co. (hereinafter called "Garvin-Bantel") regarding the tax-saving plan which he and said attorney had formulated. Garvin-Bantel was a member of both the New York and American stock exchanges, and it also engaged in the business of acting as a "money broker." In this latter capacity its function was to arrange loans on behalf of third parties with various banks with which it had working arrangements, in consideration for commissions paid to it by such banks.

Thereafter on December 29, 1958, one of Garvin-Bantel's officers or employees, acting pursuant to said consultations with Bernard, contacted the First National Bank of Jersey City (hereinafter called the "Jersey City bank"), and arranged for said bank to make a "loan" to Tillie in the amount of $465,000; which "loan" would be evidenced by a personal promissory note of Tillie, maturing on October 15, 1961; on which "loan" Tillie would prepay "interest"

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at 4 percent per annum; and which "loan" would be "secured" by $500,000 face amount of Treasury 1½'s due October 1, 1961, which were to be ordered for the Jersey City bank by Garvin-Bantel. The Jersey City bank agreed to this arrangement for the "loan," without any of its officers or employees seeing or talking either to Tillie or to Bernard, and also without them making any investigation of the credit or financial standing of Tillie or of her husband, Kapel. Indeed, the bank's records erroneously listed the

occupation of Kapel as a "Retired Gormet," when in fact he was a retired garment worker.

On the next day, December 30, 1958, one of Garvin-Bantel's officers or employees called Malon S. Andrus, Inc. (hereinafter called "Andrus"), a dealer in Government securities, and arranged for Andrus to sell to the Jersey City bank $500,000 face amount of Treasury 1½'s, due October 1, 1962, at 92.30,[1] (or $464,687.50) plus accrued interest of

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$1,875. Andrus paid a commission to Garvin-Bantel of 1/32 on said notes (or $156.60) in respect to this transaction—all of which commission was retained by Garvin-Bantel and not credited to Tillie. Andrus' records indicated that the transaction was a sale by it to the Jersey City bank as a principal, there being no indication therein that the securities were purchased for the account of any customer of the bank. Andrus had no record or knowledge concerning Tillie Goldstein.

On the following day of December 31, 1958, Andrus' representative delivered to the Jersey City bank as principal, said $500,000 face amount of the 1962 Treasury 1½'s, against payment by the bank of $464,687.50, plus $1,875 accrued interest. Tillie did not provide or pay either to

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[1] The 1961 Treasury 1½'s, which originally had been intended to be purchased, were not available; and therefore arrangements were made to substitute Treasury 1½'s due October 1, 1962, but to leave the maturity date of the "loan" at October 15, 1961.

In the above figure of 92.30, the digits following the decimal point represent 32d's of a whole dollar rather than 100ths. Whenever prices of Treasury bonds and notes are hereinafter mentioned, the fractional part of a quoted price will be in terms of 32d's, viz., 99.24 will mean 99-24/32 rather than 99-24/100.

Andrus, to Garvin-Bantel, or to the Jersey City bank, any of her personal funds or other assets toward the price of the principal amount of said securities.

Prior to December 31, 1958, Garvin-Bantel prepared for Tillie's signature: (1) A promissory note made payable to the Jersey City bank in the amount of $465,000; and (2) a letter of instructions to the Jersey City bank, wherein that bank was requested to receive the $500,000 face amount of 1962 Treasury 1½'s as "collateral" on the "loan" which Tillie was about to make. After Tillie had signed both of these instruments, Garvin-Bantel transmitted them to the

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Jersey City bank, together with two checks of Tillie: One for $52,596.61, purportedly to represent "interest" prepaid on the "loan" to October 15, 1961; and the other representing interest which had accrued on the Treasury 1½'s prior to the time of their purchase. The said promissory note which Tillie executed, was undated; and it bore the following typewritten statement on the face thereof: "Either party has the right to accelerate the maturity of this note after 30 days." Garvin-Bantel delivered all of these instruments to said bank on December 30 or 31, 1958.

The Jersey City bank, upon its receipt of the above-mentioned undated promissory note of Tillie, stamped thereon the date of December 31, 1958; and it then entered the transaction on its books of account as a "loan" to Tillie. No officer of the Jersey City bank ever talked to Tillie, ever saw Tillie, or witnessed Tillie's signing of the promissory note.

The bank's records showed that the above promissory note was to bear interest at 3⅞ percent (as distinguished

from the 4 percent rate stated on the face of the note itself); and that the bank paid the remaining ⅛ percent (or $1,643.66) to Garvin-Bantel as a commission for arranging the "loan." There is no evidence herein that Tillie paid any of said commission to Garvin-Bantel; and her 1958 Federal income tax return makes no reference to payment of any such commission. The promissory "note," in addition to being secured by the Treasury 1½'s, was also in

effect secured by the unearned portion of the "prepaid interest" which Tillie had deposited with the bank in the manner above described.

Approximately 3½ months after the foregoing steps of this transaction had been completed, the Jersey City bank decided to terminate the transaction; and in this connection, it wrote Garvin-Bantel a letter dated April 22, 1959, which read as follows:

> Gentlemen:
>
> At present, the subject [Tillie Goldstein] owes us $465,000., on a loan arranged thru your office drawn to mature October 15, 1961. After reviewing our anticipated requirements for the immediate future, it has been deemed necessary to exercise the thirty day call privilege in connection with this loan to the extent of calling it for payment on June 20th next.

The bank did not notify Tillie directly, that it was calling said "loan"; but Garvin-Bantel advised Tillie of the Jersey City bank's decision.

Shortly after the Jersey City bank issued the above letter to Garvin-Bantel, the latter firm contacted the New York brokerage firm of Gruntal & Co., members of the New York and American stock exchanges, and arranged for said firm to become the substitute lending institution for handling Tillie's "loan." As the result of this arrangement, Gruntal then wrote a letter to Tillie on June 8, 1959, as follows:

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> We are writing you at the sugestion of Messrs. Garvin, Bantel & Co., who informed us you wish to carry for your account:
>
> $500,000. U. S. Treasury 1½%
> due 10/1/62
>
> against an approximate debit of about $435,000. [sic] with 5 points margin to be maintained at all times.
>
> We are willing to carry these for you at an interest rate of ¼% above money cost to us.
>
> In accordance with the above, will you kindly execute the three enclosed cards, necessary for the opening of an account, and return them to us?

On the following day of June 9, 1959, prior to receiving any reply from Tillie, Gruntal went ahead and made arrangements to take over the 1962 Treasury 1½'s from the Jersey City bank. Also on that date, prior to receiving any instructions from Tillie, the Jersey City bank made arrangements to deliver the Treasury note to Gruntal. Alan Stypeck of Garvin-Bantel personally arranged and handled the transaction between Gruntal and the Jersey City bank. There is no evidence that Garvin-Bantel received any fee

from Tillie for such service; and Tillie did not deduct any brokerage fee in her 1959 income tax return.

Also on June 9, pursuant to the above-described arrangement, the Jersey City bank delivered the 1962 Treasury 1½'s to Gruntal; received in return Gruntal's check for $465,000; and thereupon it marked Tillie's promissory note

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as being fully "paid," and completely closed its account with her. Also at the same time, the Jersey City bank delivered to Gruntal its check for $42,944.61, which it described as being the portion of Tillie's "prepaid interest" of the $52,596.61 claimed as a deduction in her 1958 return. Gruntal did not pay over to Tillie the amount of this check; but rather Gruntal credited said amount to her account with it.

On June 10, 1959, which was after the Jersey City bank and Gruntal had already consummated the foregoing steps of the transaction, Tillie mailed to the Jersey City bank a letter that had been prepared for her signature, in which she requested the bank to deliver to Gruntal the Treasury 1½'s and the check for unearned "interest." Also at this same time, Tillie delivered another letter to Gruntal in which she requested it to take delivery of said Treasury notes and the bank's check for unearned "interest." In addition, Tillie sent to Gruntal, apparently with the just-mentioned letter, a signed "General Customers Card," wherein she agreed to pay interest (the rate was *not* specified) on the debit balance of her account; and wherein she authorized Gruntal to sell any property of hers that Gruntal might have, and to close out her account if Gruntal for any reason, deemed it necessary to do so.

Subsequently on December 1, 1959, Gruntal notified Tillie that it had sold the above-mentioned $500,000 face amount

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of 1962 Treasury 1½'s at 91.26 (or $459,062.50) plus accumulated interest of $1,270.49, and less a commission of $78.13—for a net amount of $460,254.86. Tillie thus sustained a capital loss on this sale in an amount of approximately $5,700.

On the same date of December 1, 1959, Gruntal further notified Tillie that it had bought $500,000 face amount of U. S. Treasury Bonds, 2½ percent series, due November 15, 1961 (hereinafter called "1961 Treasury 2½ Bonds"), at 95.13 (or $477,031.25) plus accrued interest of $583.79 and commission of $78.13, or a total amount of $477,693.17.

Thereafter on February 4, 1960, Gruntal notified Tillie that it had sold one-half of her 1961 Treasury 2½ Bonds ($250,000 face amount) at 96.17 (or $241,328.13) plus accrued interest of $1,407.97, less commission of $78.13, or a net amount of $242,657.97. And subsequently, on June 13, 1960, Gruntal notified Tillie that it had sold the remaining $250,000 of 1961 Treasury 2½ Bonds, at 98.26 (or $247,031.25) plus accrued interest of $509.51, less commission of $156.25, or a net amount of $247,384.51. Tillie realized an aggregate gain of $11,015.62 on the two above sales of the 1961 Treasury 2½ Bonds. Her account with Gruntal was closed out on June 25, 1960.

The rates of interest which were charged to Tillie by Gruntal were from time to time increased during the period

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of the transaction, from 4 percent to 4⅜ percent, to 4⅝ percent, to 5¼ percent, and finally to 5½ percent.

Findings of Fact and Opinion of the Tax Court

Facts re Transactions Involving Treasury 1½'s Maturing October 1, 1961

At approximately the same time in December 1958, that Bernard, acting on behalf of Tillie, initiated the above-mentioned "loan" transaction with Garvin-Bantel, he also initiated another similar but separate half-million "loan" transaction with The Royal State Bank of New York (hereinafter called the "Royal bank"). The record does not establish the details of the negotiations between Bernard and the Royal bank; but it does establish that on December 30, 1958, the president of the Royal bank called C. J. Devine & Co., a dealer in Government securities; and that he then purchased $500,000 face amount of U. S. Treasury Notes, 1½% series, due October 1, 1961, at 95.6, plus accrued interest of $1,875, or a total of $477,812.50.

On the following day, December 31, 1958, the Royal bank recorded a "loan" to Tillie of $480,000, on its books of account.[2] And on this same day, Tillie executed a promis-

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sory note in favor of the Royal bank in the face amount of $480,000, due June 30, 1960. No rate of interest was specified on said promissory note—said instrument providing only that it was "with interest from and after maturity at the legal rate." Under the terms of this promissory note, the Royal bank could sell the Treasury Notes at any time and cancel the loan.

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[2] The record herein does not establish the disposition made by the bank of the difference of $2,187.50 between the "loan" of $480,000 and the "purchase price" of $477,812.50 for the 1961 Treasury 1½'s.

On December 30, 1958, Tillie paid to the Royal bank, by means of a check drawn in her behalf by Bernard as attorney, $28,800—purportedly as "prepaid interest" on said $480,000 promissory note to its maturity 18 months later.

Subsequently, about 5 months later, on June 3, 1959, the Royal bank wrote the following letter to Tillie:

> In view of the continued depreciation in the Government Bond market, which has reduced the value of your collateral, and the rise in interest rates, we herewith request that you either liquidate your loan at this bank or pay us an additional sum of $2,600, which represents [increased] interest of ½ of 1% per annum on your note of $480,000 for the period of June 1, 1959 to June 30, 1960.
>
> Please advise immediately whether you will liquidate this loan or pay the additional interest charge.

On June 8, 1959, Tillie acting in response to the foregoing, forwarded her check to the Royal bank in the amount of $2,600, purportedly as such additional prepaid interest on her "loan."

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Subsequently, on September 22, 1959, the Royal bank called for still more collateral; and Bernard thereupon forwarded to the bank for that purpose, a savings and loan association passbook of Tillie's, having a balance of $4,500.

Thereafter on June 10, 1960, the Royal bank informed Tillie that it had sold the above-mentioned $500 000 face amount of 1961 Treasury 1½'s at 97.14 (or $487,187.50) plus interest of $1,434.43, or a total of $488,621.93. It then

applied $480,000 of such sum against her "loan," and credited the balance of $8,621.93 to her account. In addition, the bank informed Tillie that it was rebating $1,200 of the "prepaid interest" which had not been earned.

The record contains no evidence that Tillie paid any commission in connection with the "purchase" or the "sale" of the 1961 Treasury 1½'s; or that she supplied from her own personal funds or assets, any portion of the cost of the securities purchased.

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Facts re Economic Consequences of Treasury Obligations Transactions

On or about January 1, 1959, which was a day or two after both of the above-described transactions had been initiated, Bernard made a computation to reflect the portion of sweepstakes winnings that he expected Tillie would be able to retain after payment of Federal and state income taxes, if his tax-saving plan proved to be successful. Bernard's computation was as follows:

Estimated Calculation of Money Retained from Irish Sweepstakes

Income		*Disbursements*	
1958 [Sweepstakes winnings]	140,000.00	Fed. tax	13,914.04
		State tax	8,807.66
		Charities	1,300.00
		Fees (incl. 3000 BG*)	6,500.00
		Tip—Katherine	1,000.00
		Prepaid interest [to Jersey City and Royal banks]	81,396.61
	140,000.00		112,918.31
Less disbursements	112,918.31		
	27,081.69		
1959			
Interest collected	15,000.00	State tax	None
Less Accrued Int. Paid	3,750.00	Federal tax	1,700.00
	11,250.00		
Less Federal tax	1,700.00		
	9,550.00		

1960

Interest 500 M 1 yr.	7,500.00	State tax	None
" 500 M ½ year	3,750.00	Federal tax	3,800.00
	11,250.00		
Cap. Gain 1961—Bonds Estimated. S.P.—98-6/32			
Cost 95-6/32			
Cap. Gain = 15,000	15,000.00		
	26,250.00		
Less Federal tax	3,800.00		
	22,450.00		

1961

Interest 500 M 9 Mo. ..	5,625.00	State tax	150.00
Estimated Cap. Gain S.P.—98-6/32		Federal tax	3,600.00
Cost = 92-30/32	26,250.00		3,750.00
	31,875.00		
Less Fed. & State tax	3,750.00		
	28,125.00		

Findings of Fact and Opinion of the Tax Court

Summary of Money Retained		*Federal Taxes*
1958	27,081.69	13,914.04
1959	9,550.00	1,700.00
1960	22,450.00	3,800.00
1961	28,125.00	3,600.00
[Tillie]	87,206.69	23,014.04
B.G.*	2,200.00	
[Grand total]	89,406.69	

*The initials "B.G." appearing in the foregoing calculation refer to petitioner's son, Bernard Goldstein. The amounts appearing opposite said initials were paid to Bernard for services in carrying out the securities transaction.

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The foregoing computation reflected that Tillie would sustain an economic loss in excess of $18,500 on the two projected bank-loan transactions, calculated as follows:

Total "prepaid interest" outlay to Jersey City and Royal banks			$81,396.61
Less:			
Interest on Treasury obligations to be received in 1959	$15,000		
Deduct accrued interest paid at time of purchase	3,750	$11,250	
Interest to be received in 1960		11,250	
Interest to be received in 1961		5,625	
Total interest to be received		$28,125	
Capital gain anticipated in 1960		15,000	
Capital gain anticipated in 1961		26,250	69,375.00
Net economic loss			$12,021.61
Add: Fees to Bernard and tax counsel			6,500.00
Total planned economic loss			$18,521.61

Notwithstanding that these computations reflected that Tillie would sustain a total planned economic loss of over $18,500 on the two bank loan transactions, it was believed that she would derive a substantial income tax saving for the year 1958, through deducting in that year against her Irish Sweepstakes winnings, all of the "prepaid interest" to the banks for subsequent periods of from 1½ years to 2½ years.

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The way the two bank loan transactions actually worked out, was that Tillie sustained a "total economic loss" on these transactions in the amount of $25,019.01, as shown by the following:

Transactions with Jersey City bank			
Prepaid interest	$52,596.61		
Less: Unearned portion rebated	42,944.61		
Net interest outlay		$ 9,652.00	
Interest income on Treasury Note:			
April 1959 payment	$ 3,750.00		
Less: Accrued interest at time of purchase	1,875.00	1,875.00	
Excess of interest outlay over interest income (loss)			($7,777.00)
Account with Gruntal & Co.			
Total interest outlay		$17,393.11	
Less: Net interest from Treas. Notes		9,479.18	
Excess of interest outlay over interest income		$ 7,913.93	
Add: Loss on sale of 1962 Treasury 1½'s		5,703.13	
		$13,617.06	
Less: Gains on sales of 1961 Treasury Bonds		11,015.62	
Net excess of interest outlays over interest income and gains (loss)			($2,601.44)

Transactions with Royal State Bank

Net total interest prepayments	$30,200.00	
Less: Interest income received on Treas. Notes	10,809.43	
Excess of interest outlay over interest income	$19,390.57	
Less: Gain on sale of 1961 Treasury 1½'s	11,250.00	
Net excess of interest outlays over interest income and gains (loss)		($ 8,140.57)

Recapitulation

Loss on Jersey City Bank transactions	($ 7,777.00)
Loss on Gruntal & Co. account	(2,601.44)
Loss on Royal State Bank transactions	(8,140.57)
Total	($18,519.01)
Add: Fees to Bernard and tax counsel, as shown on Bernard's computation	6,500.00
Total actual economic loss to Tillie	($25,019.01)

Findings of Fact and Opinion of the Tax Court

Tillie and her husband, on the joint income tax return which they filed for the year 1958, deducted the amounts of $52,596.61 and $28,800 (total $81,396.61) which Tillie paid to the Jersey City and Royal banks, respectively. Both of these amounts, as before shown, were paid on December 31, 1958, purportedly as prepaid interest for periods extending for 1½ to 2½ years thereafter. As above found, $42,944.61 of the $52,596.61 deducted by Tillie on her 1958

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return in respect of the December 31, 1958, payment to the Jersey City bank, was rebated to her by that bank about 6 months later, following that bank's decision to terminate its transactions with her.

The respondent, in his statutory notice of deficiency herein, disallowed said claimed interest deduction; and he explained such action as follows:

> The deduction claimed for alleged interest expense in the amount of $81,396.61 for the taxable year 1958 is disallowed for the reason that the transactions were devoid of profit motive, that the transactions were entered in merely to reduce your federal income taxes, that the transactions constitute a sham consisting of form without substance, and that the $81,396.61 does not constitute a payment of interest on an indebtedness within the purview of section 163(a) of the Internal Revenue Code of 1954.

Findings of Ultimate Fact

Tillie's purpose in entering into the transactions with the Jersey City and the Royal banks was not to derive any economic gain or to improve her beneficial interest; but was

solely an attempt to obtain an interest deduction as an offset to her sweepstakes winnings.

No genuine "indebtedness" was created by Tillie with either of the above-mentioned banks, within the intendment of section 163 (a) of the 1954 Code.

As payments of interest, the transactions with said banks were shams.

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OPINION

We must decide in this case whether, in the light of recent judicial authorities which have construed and applied section 163 (a) of the 1954 Code, Tillie is entitled to the deduction of $81,396.61, which she claimed to be "prepaid interest" on two newly created items of "indebtedness," aggregating $945,000. Section 163 (a) provides a deduction for *"interest paid* or incurred within the taxable year *on indebtedness."* [Emphasis supplied.]

In the recent case of *Joseph H. Bridges,* 39 T. C. 1064, 1075, affd. (C. A. 4) 325 F. 2d 180, which involved an issue and facts strikingly similar to those in the instant case, this Court said:

> The statute [section 163 (a)] says nothing about the motive or purpose for incurring the indebtedness and paying the interest and, except as provided in sections 264-267, which are not pertinent here, makes no requirement with respect to the use to which the borrowed money is put. However, the Supreme Court in *Knetsch* v. *United States,* 364 U. S, 361 (1960), and other courts in numerous cases * * * have indicated that the statutory allowance presupposes that the indebtedness not be a sham or incurred in a sham transaction. This

means that the term "interest" as used in the statute has a commercial connotation [—] that is, regardless of the purpose for which the money is borrowed or the use to which it is put, and regardless of any tax consequences resulting therefrom, the amounts paid as interest must have commercial reality, there must be some valid commercial reason for paying interest, the borrower must in fact receive something in the trans-

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action itself which would warrant the payment of interest. To be deductible the amounts must, in fact, constitute interest—that is, compensation for the use or forbearance of money, * * * paid with respect to genuine indebtedness. * * *

The Court, after reviewing the facts in said case, further stated: "As a payment of interest, this transaction was a sham."

The Court of Appeals for the Fourth Circuit, in affirming the decision of this Court in the *Bridges* case, made the following pertinent statements:

> Transactions which are properly characterized as mere shams cannot be given effect for purposes of creating tax advantages, since in order to give that effect to the transaction it must be clear that what was done was, in reality, that which the statute intended. Knetsch v. United States, 364 U. S. 361, 81 S. Ct. 132, 5 L. Ed. 2d 128 (1960); Gregory v. Helvering, 293 U. S. 465, 55 S. Ct. 266, 79 L. Ed. 596 (1935).
>
> Upon the particular facts of this case, we are of the opinion that the Tax Court's finding that as payments

of interest on indebtedness the transactions here involved were shams is not only not clearly erroneous but is compelled when we apply the test set forth by the Supreme Court in Knetsch v. United States, supra.

* * * * *

* * * The test in such a case as the one under review here is not whether the motive or intent of the taxpayer in entering into the transaction was, partially or solely, to decrease or avoid his taxes, but is "whether what was done, apart from the tax motive, was the thing which the statute intended." Knetsch v. United States, supra, 364 U. S. at 365, 81 S. Ct. at 134-135, 5 L. Ed. 2d 128; Gregory v. Helvering, supra, 293 U. S. at 469,

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55 S. Ct. at 267-268, 79 L. Ed. 596. It is clear that what was intended by section 163(a) was to create a deduction for all interest paid or accrued on *indebtedness*. The question here is whether the payments made by Bridges to the banks were, in fact, interest, i.e., "compensation for the use or forbearance of money,"[3] paid with respect to a genuine indebtedness.[4]

Although the particular transaction involved in the case of Knetsch v. United States, 364 U. S. 361, 81 S. Ct. 132, 5 L. Ed. 2d 128 (1960), consisted of the purported purchase of an annuity contract with funds purportedly borrowed from the insurance company which "sold" the annuity contracts, the repayment of the "borrowed" funds being secured by the annuity contracts, the principles there laid down by the Supreme Court are not only applicable, but controlling, in the determination of the instant case.[5]

Findings of Fact and Opinion of the Tax Court

The Court in Knetsch held that the tax reduction motive or intent is immaterial in such cases and that the determinative question as to "whether what was done apart from the tax motive, was the thing which the statute intended" is answered in the negative if it is apparent "that there was nothing of substance to be realized by [the taxpayer] from [the] transaction beyond a tax deduction." There the Court concluded that it was clearly apparent that "Knetsch's transaction with the insurance company did 'not appreciably affect his beneficial interest except to reduce his tax.'" In view of such a finding, the Court held that the transaction was a sham and did not create an "indebtedness" within the intent of the interest deduction statute. * * *

In the instant case Bridges entered into two transactions, as to each of which he agreed to and did pay out substantially more money than he could even hope to recover from any increase in value of the securities he purchased. In other words, it is clear that there was no prospect whatever of any financial profit from the transactions alone. * * * In neither case did Bridges, *at any time,* have the uncontrolled use of additional money, of the securities he had purchased

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or of the interest on the securities. * * * there was never any benefit extended by the banks to Bridges and never any risk assumed by the banks. Assuredly, taxpayer did not receive money or equivalent economic benefits in the amount of the bank loans. Actually, no real indebtedness was created and the Tax Court was

fully justified in finding that, as payments of interest "on indebtedness," the transactions were shams. Paraphrasing the language of the Supreme Court in Knetsch, it is patent that there was nothing of substance to be realized by Bridges from either transaction beyond a tax deduction; and plainly the transactions did not in any wise affect his beneficial interest except to reduce his tax.

Bridges relies quite heavily upon * * * L. Lee Stanton, 34 T. C. 1 (1960). The Stanton case is clearly distinguishable on its facts from the instant case. * * * [Also] it will be noted that the case was decided prior to and without the benefit of the decision of the Supreme Court in Knetsch. * * * [Footnotes omitted.]

As regards the Supreme Court's decision in the *Knetsch* case which was cited and relied upon in the opinion of this Court and that of the Fourth Circuit in the *Bridges* case, we deem it unnecessary to here further review the principles which the Supreme Court therein enunciated. It should be noted however, that the Supreme Court in deciding said case, cited with approval the dissenting opinion of Judge Learned Hand in *Gilbert* v. *Commissioner* (C. A. 2), 248 F. 2d 399, 411, wherein it was stated:

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The Income Tax Act imposes liabilities upon the taxpayers based upon their financial transactions, and it is of course true that the payment of the tax is itself a financial transaction. *If, however, the taxpayer entered into a transaction that does not appreciably affect his beneficial interest except to reduce his tax, the law*

> *will disregard it; for we cannot suppose that it was part of the purpose of the act to provide an escape from the liabilities that it sought to impose,* * * * [Emphasis supplied.]

In the instant case, after carefully reexamining and reweighing all the evidence and also after carefully reconsidering all pertinent judicial authorities (as was urged upon us by the petitioners in their above-mentioned motion for reconsideration), we have concluded that this case is indistinguishable *on principle* from the above-cited *Knetsch* and *Bridges* cases; and that (to adopt the words of the Fourth Circuit) "the principles * * * laid down by the Supreme Court [in the *Knetsch* case] are not only applicable, but controlling, in the determination of the instant case." We have further concluded and have heretofore found as an ultimate fact, that (as we said in the *Bridges* case), "As payments of interest, the transactions [with the banks here involved] were shams." And thus it follows that the deductions here in controversy are not allowable.

A careful weighing of the relevant evidence convinces us that there was no genuine indebtedness established between Tillie and either the Jersey City bank or the Royal bank. Despite Tillie's assertion that she was borrowing almost a

million dollars from these banks, not a single officer or employee of either bank ever laid eyes on Tillie Goldstein. Neither bank made any investigation or check of the credit standing or financial status of either Tillie or of her husband. In our judgment, there was never any intention to

establish a bona fide debtor-creditor relationship between Tillie and the banks. Rather, we think that the banks were looking to the Treasury obligations (and not to the purported "debtor," Tillie) to recover the funds which, in their entirety, had been supplied by the banks to acquire said Treasury obligations. In this connection, it is to be noted that Tillie actually did not expend so much as a penny for the Treasury obligations, despite the fact that she claims she was investing therein. All of the money which she paid to each bank was for so-called "prepaid interest."

It appears to us that a transaction, such as Tillie entered into with the Jersey City and Royal banks, represents in substance and reality, an investment *by the bank* in Treasury obligations; wherein the bank, in consideration for prepayment to it of "interest" by a customer such as Tillie (at a higher rate than that which the Treasury obligations would yield), would carry such Treasury notes in the customer's name as purported "collateral" for the "loan." The foregoing would serve to lend a semblance of color to any assertion of the customer that he was indebted to the

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bank, and that what he paid to the bank was interest, deductible for Federal income tax purposes. But, as our above holding reveals, we do not believe that there would, in such circumstance, be any genuine indebtedness between the bank and its customer. And if it is necessary to characterize the customer's payment, we would say that it was a fee to the bank for providing the "facade" of a loan transaction. Cf. *Knetsch* v. *United States, supra,* 364 U. S., p. 366.

Still guided by the *Knetsch* and *Bridges* cases, we further look to see whether in the instant case, Tillie's transactions with the banks could appreciably affect her "beneficial interest" in any way except to reduce her tax. If saving 1958 income taxes was the only significant benefit to be derived by her, then the *Knetsch* and *Bridges* cases require that the deduction for so-called "prepaid interest" must be denied. In terms of prepaid interest expense plus the fee to Bernard and tax counsel vs. interest income, these transactions necessarily had to produce losses, as is shown in the following computation based upon our Findings of Fact:

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	Royal bank (18-month promissory note)	Jersey City bank (2 yr. 9½ mos. promissory note)	Total
Prepaid interest	$28,800	$52,596.61	$81,396.61
Interest income (1½% per yr.)	11,250	20,937.50	32,187.50
Excess of interest expense over interest income	$17,550	$31,659.11	$49,209.11
Add: Fee to Bernard and to tax counsel	3,250	3,250.00	6,500.00
Total loss (not including income taxes on interest income)	$20,800	$34,909.11	$55,709.11

To recoup the above losses, Bernard's plan relied upon sales of the Treasury notes at higher prices than were paid for them. But, in order for Tillie to just break even without any profit on the prepaid interest and counsel fees

totaling $87,896.61 which she had tied up in these transactions, the Treasury notes involved would have had to be sold for approximately par, exclusive of brokerage commissions. And for Tillie to have realized anything substantial beyond recovering her said outlay, the Treasury notes would have had to be sold considerably in excess of par, notwithstanding that they bore interest of only 1½ percent, and were to mature at par only a very short time later.

Moreover, the foregoing computations are weighted in Tillie's favor, for they do not reflect any of the Federal or state income taxes which would definitely burden the

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interest income on said Treasury notes, and also would definitely burden any gain realized on their subsequent sale.

Included in our Findings of Fact is another computation, based on estimates made by Bernard on or about January 1, 1959, which shows that Tillie's transactions had a built-in planned economic loss of $18,521.61; and our findings further reveal that Tillie's transactions actually resulted in a loss to her of $25,019.01.

Interest is the compensation for the use or forbearance of money. *Deputy* v. *du Pont,* 308 U. S. 488. In the instant case, Tillie did not at any time have either uncontrolled use of any additional money, or of the securities which were purchased ostensibly for her.

In the light of all the foregoing, we are impelled to conclude, in line with our finding of ultimate fact, that there was nothing of substance to be realized by Tillie from her transactions with the banks, except a tax deduction. Tillie did not have and could not reasonably have had any purpose

or intention through the foregoing transactions, to appreciably affect her beneficial interest except to reduce her taxes. Absent the significant income tax savings inuring to Tillie from deducting at one fell swoop in 1958, all of the "prepaid interest" for periods of 1½ to 2½ years thereafter, Tillie's putative borrowing transactions do not make sense either commercially or economically.

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Tillie places strong reliance upon this Court's opinion in *L. Lee Stanton*, 34 T. C. 1. That case is distinguishable here for the reasons set forth in *Max Barnett*, 44 T. C. —— (decided this day).

We hold that the deductions claimed by Tillie on her 1958 return for amounts paid to the Jersey City and Royal banks as "prepaid interest," do not represent "interest paid * * * on indebtedness" within the intendment of section 163 (a) of the 1954 Code; and accordingly that such deductions are not allowable. The respondent's determination is sustained.

Reviewed by the Court.

Decision will be entered for the respondent.

FORRESTER and HOYT, *JJ.*, dissent.

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FAY, *J.*, dissenting: It is clear that a taxpayer has a legal right to decrease the amount of what would otherwise be his taxes or altogether avoid them. *Bridges* v. *Commissioner*, 325 F. 2d 180 (C. A. 4, 1963), affirming 39 T. C. 1064 (1963). The test in such a case as the one at bar is not whether the motive or intent in entering into the transaction

was, solely or partially, to decrease or avoid taxes, but is "whether what was done, apart from the tax motive, was the thing which the statute intended." *Bridges* v. *Commissioner, supra,* at 184. Unlike other deduction provisions, section 163 does not require that the expenditure be ordinary, necessary, reasonable, or in connection with a transaction entered into for profit. It is clear that what was intended by section 163(a) was to create a deduction for *all* interest paid or accrued on indebtedness. *Bridges* v. *Commissioner, supra.*

I disagree with the majority's conclusion that there was no genuine indebtedness established between Tillie and either the Jersey City bank or the Royal bank. Upon careful scrutiny of the record, I am convinced that the transaction in question was not merely an exercise in financial

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mummery.[1] Whatever her ultimate purposes, I do not doubt that Tillie contracted an actual indebtedness in the usual sense of the term.

In its findings of fact and in the body of its opinion, the majority points out certain aspects of the loan transaction upon which it concludes that no genuine indebtedness was

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[1] That is to say, the transaction involved here is not similar to that presented in *Eli D. Goodstein,* 30 T. C. 1178 (1958), affd. 267 F. 2d 127 (C. A. 1, 1959), and the cases which might be described as the progeny of the tax-canny Livingstone, i.e., *Sonnabend* v. *Commissioner,* 267 F. 2d 319 (C. A. 1, 1959), affirming per curiam a Memorandum Opinion of this Court; *Broome* v. *United States,* 170 F. Supp. 613 (Ct. Cl., 1959); *George G. Lynch,* 31 T. C. 990 (1959), affd. 273 F. 2d 867 (C. A. 2, 1959); *Leslie Julian,* 31 T. C. 998 (1959), affd. sub nom. *Lynch* v. *Commissioner,* 273 F. 2d 867 (C. A. 2, 1959); *Egbert J. Miles,* 31 T. C. 1001 (1959). See also *Gordon MacRae,* 34 T. C. 20 (1960), affd. in part and remanded in part 294 F. 2d 56 (C. A. 9, 1961).

created. However, the record clearly indicates that the loan transaction was in every respect regular and, moreover, indistinguishable from any other legitimate loan transaction contracted for the purchase of Government securities. To hold that the indebtedness in issue is not genuine because it fails to meet certain theoretical judicial standards which have no counterpart in commercial practice places an unwarranted construction on the terminology employed in section 163. Although the interest deduction is purely a creature of tax law, indebtedness and payment of interest thereon is a common transaction in the nontax field. Since the terms "interest" and "indebtedness" are used in the Code without limiting definition and without legislative history indicating a contrary result, their *common and ordinary meaning* in the commercial field should at least be persuasive of their meaning as used in the Internal Revenue Code. Compare *Commissioner* v. *Clay B. Brown*, —— U. S. —— (1965).

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Regardless of how the transactions in issue are viewed, I have no doubt that the loan and note, the purchase and pledge of collateral, and the sale and satisfaction of the loan were in every respect genuine financial and commercial transactions upon which tax consequences should be based. In sum effect, I believe Tillie actually paid, as interest, with respect to the aforesaid borrowings, some $80,000. Hence, I find no substance to the majority's determination that there was no debtor-creditor relationship.

The majority opinion is not confined to presenting the factual conclusion that no true indebtedness existed. It suggests that even if the loan transaction met the literal

requirements of the provisions authorizing interest deductions, it lies outside the "intent" of the statute and is, in that respect, a "sham." This amounts to saying that the transaction was a sham because entered into for the "wrong" motives—that is, for tax reduction motives.

The majority opinion indicates that the transactions involved constituted merely a sophisticated tax avoidance scheme destined to produce nothing in the way of an economic reward except a substantial reduction in taxes.[2] But

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this describes neither a sham transaction, nor one unmarked by events or risks beyond the control of the taxpayer, nor one different in substance and effect from what it appeared to be on its face. *Fabreeka Products Company* v. *Commissioner,* 294 F. 2d 876 (C. A. 1, 1961), remanding 34 T. C. 290 (1960). Although the existence of a tax motive creates the necessity for a searching inquiry into the substance of a transaction, it is my opinion that a transaction which in substance creates a real indebtedness (upon which interest is due and paid) need not be entered into with the affirmative motive of "investment" in order to come under section 163. *Fabreeka Products Company* v. *Commissioner, supra.* That is to say, I do not believe that motives of tax

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[2] In the majority opinion it is stated:

> [T]here was nothing of substance to be realized by Tillie from her transactions with the banks, except a tax deduction. Tillie did not have and could not reasonably have had any purpose or intention through the foregoing transactions, to appreciably affect her beneficial interest except to reduce her taxes. Absent the significant income tax savings inuring to Tillie from deducting at one fell swoop in 1958, all of the "prepaid interest" for periods of 1½ to 2½ years thereafter, Tillie's putative borrowing transactions do not make sense either commercially or economically.

avoidance can so contaminate an otherwise legitimate transaction as to rob it of all reality. *Commissioner* v. *Clay B. Brown, supra.*

I believe that the case at bar is controlled by this Court's holding in *L. Lee Stanton,* 34 T. C. 1 (1960). The transactions in issue involved just as real and bona fide borrowings by Tillie as the loan which Stanton obtained; and, hence, the instant case cannot be distinguished on its facts from *Stanton.*

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In *L. Lee Stanton, supra,* at 7, this Court pronounced with respect to section 23(b), now section 163:

> Congress having enacted the only exceptions it desired to make [see section 163(d)], the maxim of interpretation, *"Inclusio unius est exclusio alterius"* applies, e.g., Congress intended no other exception or limitation on the deductibility of interest on indebtedness. All interest paid within the taxable year on genuine indebtedness of any other kind thus entitles a cash basis taxpayer to a deduction of the amount of interest paid. * * *

This Court emphasized this point by stating:

> Congress has indicated that this deduction is not dependent in any other way upon the purpose or motive of the borrower, or the use made of the borrowed funds. * * *

The legislative history of the interest deduction provisions set out in Stanton clearly shows that "Congress has

repeatedly considered and ultimately rejected limitations somewhat comparable to the one now urged by the Commissioner" for support of his position.

The majority opinion cites *Knetsch* v. *United States*, 364 U. S. 361 (1960), and *Joseph H. Bridges*, 39 T. C. 1064 (1963), affd. 325 F. 2d 180 (C. A. 4, 1963), as determinative of the case at bar.[3] I do not read the decision of the Supreme Court in *Knetsch* as invalidating this Court's

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earlier decision in *L. Lee Stanton, supra*,[4] nor as supporting the majority's position here. In *Knetsch*, the taxpayer purchased a so-called annuity by borrowing, on nonrecourse notes,[5] the purchase price from the very insurance company which issued the annuity. The annuity served as the insurance company's collateral on the loan. The guaranteed yearly increment in cash value was substantially less than the interest to be paid on the purchase loan. Knetsch's annual borrowing of the annuity's yearly increase in cash value would, if continued (and the Court assumed it would) keep the annuity's net cash value at the "relative pittance of $1000." The annuity payments were scheduled to begin upon Knetsch's reaching 90 years of age. In *Knetsch*, the very company making the loan was the one issuing the "paper" to serve as collateral. In practical effect, there

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[3] The majority opinion states:

> If saving 1958 income taxes was the only significant benefit to be derived by her, then the *Knetsch* and *Bridges* cases require that the deduction for so-called "prepaid interest" must be denied. * * *

[4] See *Clifford F. Hood*, T. C. M. 1961-231.

[5] In the instant case, Tillie's promissory note was clearly issued *with recourse*.

was little more involved than counterbalancing book liabilities. As the Supreme Court pointed out, the difference between Knetsch's payment of interest and the amount of cash value which he borrowed constituted a fee retained by the insurance company for providing the facade of a loan whereby the taxpayer sought to reduce his taxes in the total sum of $233,297.68.

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The Supreme Court in *Knetsch* did not purport to be reshaping either the usual interpretation of "indebtedness" for the purpose of the interest deduction or the usual interpretation of "interest" in tax law. The Supreme Court emphatically put aside the trial court's finding that Knetsch's "only motive in purchasing [the] bonds was to attempt to secure an interest deduction." Motive was not relevant because, said the Supreme Court, quoting from its often cited *Gregory* v. *Helvering* opinion, 293 U. S. 465, 469, "the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended." In this regard, the Supreme Court's concern was whether the annuity contract arrangement did involve an indebtedness in the usual sense of the term. The Supreme Court did not hold that the interpretation of indebtedness carries a qualification as to the purpose for which the obligation is incurred. Consequently, I believe that the decision in *Knetsch* was confined to the particular facts presented therein, i.e., that no true indebtedness existed regardless of the taxpayer's motive.

Unlike the present case, the transaction in *Knetsch* merely provided an arrangement mutually benefiting the parties

without creating a true obligation to pay interest. In the instant case, I believe that the loan transaction was not a fiction. Instead, the transaction was real, the indebtedness genuine, even though the motive of Tillie *may* have been purely one of achieving a tax rather than economic gain.

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The jural relationship established between the banks and Tillie was one of indebtedness in the usual sense that term is used and in the sense that term is used in tax law.

I believe that the decision of this Court in *Bridges* is distinguishable on its face from the instant case. In *Bridges,* the record provided this Court with a confusing if not irregular set of facts. In one transaction, the taxpayer was able to purchase bonds below market price, which bonds were redeemed by the bank which made the loan. In another transaction, the taxpayer sold bonds above the market (1) subject to a call option on the part of the lender at par (far in excess of the market value) one month later, and (2) subject to a sale option on the part of the taxpayer at par one month later. In both the transactions, the loan amount was in excess of the market value of the bonds. This Court stated, at 1077:

> We are convinced that there was never any intent or thought between the parties that petitioner was incurring a real, personal indebtedness or obligation. * * *

The Court held that *Stanton* was distinguishable since, in *Stanton,* the transactions were bona fide and real and created a genuine indebtedness. Unlike *Bridges,* there is noth-

ing in the transactions in the case at bar to suggest irregularity.

To hold for respondent in the instant case despite the existence of a genuine indebtedness would (1) engraft upon section 163 a qualification and penalty unwarranted by the

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literal language and intendment[6] of that provision and (2) extend the limited opinion of the Supreme Court in *Knetsch*, in a manner not consonant with our judicial function. Although as a Court and as this Court in particular we must be mindful of the necessity of revenue gathering, we cannot be solicitous to that process. Our duty requires us to be solicitous to the law alone as it is written. I "consequently deem it wise to 'leave to the Congress the fashioning of a rule which, in any event, must have wide ramifications'." *Commissioner* v. *Clay B. Brown, supra.*

FORRESTER, TRAIN, DAWSON, and HOYT, *JJ.*, agree with this dissent.

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[6] See *L. Lee Stanton*, 34 T. C. 1 (1960).

Opinion of the United States Court of Appeals

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 187—September Term, 1965.

(Argued February 23, 1966 Decided July 22, 1966.)

Docket No. 29957

KAPEL GOLDSTEIN and TILLIE GOLDSTEIN,

Petitioners,

—v.—

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Before:

WATERMAN, MOORE and FRIENDLY,

Circuit Judges.

By petition to review, taxpayers seek reversal of a decision of U. S. Tax Court, Pierce, *J.*, upholding a determination by the Commissioner of Internal Revenue of a deficiency in their income tax for the calendar year 1958. The Tax Court is affirmed.

L. MEYER PINCUS, New York City, *for Petitioners.*

JONATHAN S. COHEN, Atty., Department of Justice; Richard M. Roberts, Acting Asst. Atty. Gen.; Lee A. Jackson, David O. Walter, Martin G. Goldblum, Attys., Department of Justice, *for Respondent.*

WATERMAN, *Circuit Judge*:

Tillie Goldstein and her husband[1] petition to review a decision of the Tax Court disallowing as deductions for federal income tax purposes payments totaling $81,396.61 made by petitioner to certain banks, which payments petitioner claimed were payments of interest on indebtedness within Section 163(a) of the 1954 Internal Revenue Code. This section provides that "There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness." Int. Rev. Code of 1954 §163(a).[2] A majority of the Tax Court held for several reasons to be considered in the body of this opinion that these payments were not deductible. *Goldstein* v. *Commissioner,* 44 T. C. 284 (1965). We affirm on one of the grounds mentioned by the Tax Court.

During the latter part of 1958 petitioner received the good news that she held a winning Irish Sweepstakes ticket and would shortly receive $140,218.75. This windfall significantly improved petitioner's financial situation, for she

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1 Tillie Goldstein, whose income is involved here, filed a joint return with her husband, Kapel Goldstein, for the calendar year 1958. Therefore, though husband and wife are joint petitioners in the case, we use "petitioner" throughout this opinion to indicate this fact and to show that Kapel Goldstein is involved only because of the filing of the joint return.

2 Unless otherwise stated, all references to Code sections are to the 1954 Internal Revenue Code. Hereafter the Code will usually be referred to only by Section.

was a housewife approximately 70 years old and her husband was a retired garment worker who received a $780 pension each year. In 1958 the couple's only income, aside from this pension and the unexpected Sweepstakes proceeds, was $124.75, which represented interest on several small savings bank accounts. The petitioner received the Sweepstakes proceeds in December 1958 and she deposited the money in a New York bank. She included this amount as gross income in the joint return she and her husband filed for 1958 on the cash receipts and disbursements basis.

Petitioner's son, Bernard Goldstein, was a certified public accountant, practicing in New York in 1958. In November of that year Bernard either volunteered or was enlisted to assist petitioner in investing the Sweepstakes proceeds, and in minimizing the 1958 tax consequences to petitioner of the sudden increase in her income for that year. A series of consultations between Bernard and an attorney resulted in the adoption of a plan, which, as implemented, can be summarized as follows: During the latter part of December 1958 petitioner contacted several brokerage houses that bought and sold securities for clients and also arranged collateral loans. With the assistance of one of these brokerage houses, Garvin, Bantel & Co., petitioner borrowed $465,000 from the First National Bank of Jersey City. With the money thus acquired, and the active assistance of Garvin, Bantel, petitioner purchased $500,000 face amount of United States Treasury 1½% notes, due to mature on October 1, 1962. Petitioner promptly pledged the Treasury notes so purchased as collateral to secure the loan with the Jersey City Bank. At approximately the same time in 1958 Bernard secured for petitioner a $480,000 loan from the Royal State Bank of New York. With the assistance of the Royal State Bank petitioner pur-

chased a second block of $500,000 face amount of United States Treasury 1½% notes, due to mature on October 1, 1961. Again the notes were pledged as collateral with this bank to secure the loan. Bernard testified that the petitioner purchased the Treasury notes because he believed "the time was ripe" to invest in this kind of government obligation. Also, pursuant to the prearranged plan, petitioner prepaid to the First National Bank of Jersey City and to the Royal State Bank the interest that would be due on the loans she had received if they remained outstanding for 1½ to 2½ years. These interest prepayments, made in late December of 1958, totaled $81,396.61.[3] Petitioner then claimed this sum as a Section 163(a) deduction on the 1958 income tax return she filed jointly with her husband.

After reviewing these transactions in detail the Tax Court held the $81,396.61 was not deductible as "interest paid or accrued" on "indebtedness" under Section 163(a). In large part this holding rested on the court's conclusion that both loan transactions were "shams" that created "no genuine indebtedness." To support this conclusion the court stressed that, even though petitioner was borrowing approximately one half million dollars from each bank, the banks had agreed to the loans without any of their officers or employees having met petitioner or having investigated her financial position. The court noted that in each of the loan transactions petitioner was not required to commit any of her funds toward the purchase of the Treasury notes in their principal amount. And at several points the court appears to have attached great weight

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3 The prepaid interest on the Jersey City Bank loan totaled $52,596.61 and covered a future period of two years and 9½ months; the prepaid interest on the Royal State Bank loan totaled $28,800 and covered a future period of 1½ years.

to the fact that most of the relevant transactions were apparently conducted by Garvin, Bantel and the Jersey City Bank, or by Bernard and the Royal State Bank, without petitioner's close supervision. Taking all these factors together, the Tax Court decided that, in fact, each transaction was " . . . an investment *by the bank* in Treasury obligations; wherein the bank, in consideration for prepayment to it of 'interest' by a customer . . . would carry such Treasury notes in the customer's name as purported collateral for the 'loan.'" 44 T. C. at 299 (italics in original). The court went on to say that " . . . if it is necessary to characterize the customer's payment, we would say that it was a fee to the bank for providing the 'facade' of a loan transaction." *Ibid.*

There is a certain force to the foregoing analysis. Quite clearly the First National Bank of Jersey City and the Royal State Bank of New York preferred to engage in the transactions they engaged in here rather than invest funds directly in Treasury notes because petitioner's loans bore interest at an appreciably higher rate than that yielded by the government obligations. This fact, combined with the impeccable property pledged as security for the loans, may have induced these banks to enter into these transactions without all the panoply that the court indicates usually accompanies loan transactions of such size. Indeed, while on its face purporting to be a debtor-creditor transaction between a taxpayer and a bank, in fact there can be a situation where the bank itself is, in effect, directly investing in the securities purportedly pledged by taxpayer as collateral to taxpayer's obligation; in such a transaction the taxpayer truly can be said to have paid a certain sum to the bank in return for the "facade" of a loan transaction. For Section 163(a) purposes such transactions are

properly described as "shams" creating no "genuine indebtedness" and no deduction for the payment of "interest" to the bank should be allowed. See cases cited note 5 *infra*. Cf. *Knetsch* v. *United States*, 364 U. S. 361 (1960).

In our view, however, the facts of the two loan arrangements now before us fail in several significant respects to establish that these transactions were clearly shams. We agree with the dissent below that the record indicates these loan arrangements were " . . . regular and, moreover, indistinguishable from any other legitimate loan transaction contracted for the purchase of Government securities." 44 T. C. at 301 (Fay, *J.*, dissenting). In the first place, the Jersey City Bank and the Royal State Bank were independent financial institutions; it can not be said that their sole function was to finance transactions such as those before us. Compare *Lynch* v. *Commissioner*, 273 F. 2d 867 (2 Cir. 1959); *Goodstein* v. *Commissioner*, 267 F. 2d 127 (1 Cir. 1959). Second, the two loan transactions here did not within a few days return all the parties to the position from which they had started. *Ibid.* Here the Royal State Bank loan remained outstanding, and, significantly, that Bank retained the Treasury obligations pledged as security until June 10, 1960, at which time petitioner instructed the bank to sell the notes, apply the proceeds to the loan, and credit any remaining balance to her account. The facts relating to the Jersey City Bank loan are slightly different: this loan was closed in June 1959 when the brokerage house of Gruntal & Co. was substituted for the Jersey City Bank as creditor. Gruntal received and retained the 1962 Treasury 1½'s originally pledged as security for the loan until December 1, 1959 when, pursuant to instructions from petitioner and her advisors, these notes were sold, and $500,000 face amount of United States Treasury 2½%

bonds were purchased to replace them as security. Petitioner's account with Gruntal was not finally closed until June 13, 1960 when the last of these substituted bonds were sold, the petitioner's note was marked fully paid, and the balance was credited to petitioner. Third, the independent financial institutions from which petitioner borrowed the funds she needed to acquire the Treasury obligations possessed significant control over the future of their respective loan arrangements: for example, the petitioner's promissory note to the Jersey City Bank explicitly gave either party the right to accelerate the maturity of the note after 30 days, and it was the Jersey City Bank's utilization of this clause that necessitated recourse to Gruntal; the Royal State Bank had the right at any time to demand that petitioner increase her collateral or liquidate the loan, and on several occasions it made such a demand. Fourth, the notes signed by petitioner in favor of both banks were signed with recourse. If either of the independent lending institutions here involved had lost money on these transactions because of the depreciation of the collateral pledged to secure the loans we are certain that, upon petitioner's default of payment, they would have without hesitation proceeded against petitioner to recover their losses. Compare *Lynch* v. *Commissioner*, *supra* (nonrecourse notes). See also *Jockmus* v. *United States*, 335 F. 2d 23 (2 Cir. 1964). Moreover, all things being equal, the banks' chances of judgments in their favor would have been excellent. In view of this combination of facts we think it was error for the Tax Court to conclude that these two transactions were "shams" which created no genuine indebtedness. Were this the only ground on which the decision reached below could be supported we would be compelled to reverse.

In reaching this conclusion we recognize that at least one other United States Court of Appeals has disallowed a deduction for interest in a closely analogous case on the ground the transactions there were "sham." *Bridges* v. *Commissioner*, 325 F. 2d 180 (4 Cir. 1963).[4] We think the interest of candor is better served if the "sham" and "absence of indebtedness" rationales are reserved for cases like *Lynch* v. *Commissioner*, *supra*, and *Goodstein* v. *Commissioner*, *supra*. Different considerations govern decision as to whether interest payments are deductible by a taxpayer who borrows money from an independent lending institution, executes a promissory note with recourse, and purchases Treasury obligations that are then in fact pledged with the lender as security for the loan for a significant period of time, unless it can be concluded from other facts (not present in this case) that the transaction is simply a sham.

One ground advanced by the Tax Court seems capable of reasoned development to support the result reached in this case by that court. The Tax Court found as an ultimate fact that petitioner's purpose in entering into the Jersey City Bank and Royal State Bank transactions "was not to derive any economic gain or to improve here [sic] beneficial interest; but was *solely* an attempt to obtain an interest deduction as an offset to her sweepstake winnings." 44 T. C. at 295 (emphasis added). This finding of ultimate fact was based in part on a set of computations made by Bernard Goldstein shortly after the Jersey City Bank and Royal State Bank loan transactions had been concluded. These computations were introduced by the Commissioner

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4 Judge Boreman's opinion in *Bridges* is somewhat ambiguous; at times it would appear that it adopts a rule similar to that which we adopt in the present case. Compare 325 F. 2d at 184 with our discussion at ....., *infra*.

below and they indicated that petitioner and her financial advisors then estimated that the transactions would produce an economic loss in excess of $18,500 inasmuch as petitioner was out of pocket the 4% interest she had prepaid and could expect to receive 1½% interest on the Treasury obligations she had just purchased plus a modest capital gain when the obligations were sold. This computation also reflected Bernard's realization that if the plan was successful this economic loss would be more than offset by the substantial reduction in petitioner's 1958 income tax liability due to the large deduction for interest "paid or accrued" taken in that year. The memorandum drawn up by Bernard is set out in full in the opinion of the Tax Court. 44 T. C. 292-93. In fact, petitioner sustained a $25,091.01 economic loss on these transactions for some of the Treasury obligations were ultimately sold for less than the price that had been originally anticipated by petitioner's advisors.

Before the Tax Court, and before us, petitioner has argued that she realistically anticipated an economic gain on the loan transactions due to anticipated appreciation in the value of the Treasury obligations, and that this gain would more than offset the loss that was bound to result because of the unfavorable interest rate differential. In support of this position, Bernard testified, and documentary evidence was introduced, to the effect that in December 1958 the market for Treasury obligations was unreasonably depressed, and that many investors at that time were favorably disposed toward their purchase. In short, petitioner argued that she intended a sophisticated, speculative, sortie into the market for government securities.

In holding that petitioner's "sole" purpose in entering into the Jersey City Bank and Royal State Bank transactions was to obtain an interest deduction, the Tax Court rejected this explanation of her purpose in entering into these transactions. For several reasons we hold that this rejection was proper. First, petitioner's evidence tending to establish that she anticipated an economic profit on these transactions due to a rising market for Treasury obligations is flatly contradicted by the computations made by Bernard contemporaneously with the commencement of these transactions and introduced by the Commissioner at trial. These computations almost conclusively establish that petitioner and her advisors from the outset anticipated an economic loss. Petitioner's answer to this damaging evidence is that the set of Bernard's computations introduced by the Commissioner was only one of several arithmetic projections made at the same time by Bernard, and that Bernard intended the computations introduced by the Commissioner to represent the worst that could befall the plan if prices for government obligations continued to decline. The petitioner introduced several exhibits that purported to be reconstructions of the other arithmetic projections made by Bernard contemporaneously with the computations introduced by the Commissioner. Exhibit 83, introduced by petitioner, purported to be an arithmetic projection of petitioner's expected profit on the assumption that the market for Treasury obligations remained at the level it had reached at the close of 1958; this exhibit showed an economic profit on both transactions over a two-year period totaling a meager $2,075.00. Exhibit 84, also introduced by petitioner, purported to be an arithmetic projection of petitioner's expected profit on the assumption that the market for Treasury obligations reverted to previous

highs; this exhibit projected an economic profit on both transactions over a two year period totaling $22,875.00. The Tax Court's ground (or grounds) for refusing to credit these exhibits and related evidence does not clearly appear in its opinion, but sufficient grounds are not hard to find. First, unlike the computations made by Bernard that the Commissioner introduced, Exhibits 83 and 84 purported only to be reconstructions of calculations made by Bernard in late December 1958. The originals of Exhibits 83 and 84 were not produced; no explanation of petitioner's failure to do so was given. On this ground the Tax Court might have decided that Exhibits 83 and 84 were especially prepared for this litigation and had not entered into Tillie's calculations at the outset. Second, even if we assume Exhibits 83 and 84 represent computations made contemporaneously with petitioner's entrance into these transactions, they far from establish that the transactions were undertaken with a realistic expectation of economic profit. For example, Exhibit 83 purports to establish that, assuming the market for Treasury obligations remained constant, petitioner and her advisors anticipated an economic profit of $2,075.00 over a two year period on these transactions. But Exhibit 83 fails to reflect the $6,500 fee paid to Bernard and tax counsel for their work in planning these transactions. Once this fee is included in these computations all economic profit disappears. Inclusion of this $6,500 item similarly reduces the total economic profit as computed in Exhibit 84. Furthermore, although petitioner made an outlay of "prepaid interest" on the Royal State Bank loan for a period of 1½ years, Exhibits 83 and 84 compute the outlay on this loan as if there had been an interest payment for only one year. The payment of interest on the Jersey City Bank

loan similarly is computed on a two-year basis instead of the basis of the actual outlay, which extended for two years, nine and one half months. Such computations presuppose petitioner could, at her option, terminate the loans prior to their due dates, sell the securities, and be reimbursed for the portions of the prepaid interest not yet earned by the banks. However, neither loan agreement contains a provision entitling petitioner to be reimbursed for any unearned portion of the prepaid interest if the loan is terminated *by the petitioner* prior to the due date. And, in the case of the Royal State Bank transaction, it is not even clear that petitioner had the power to prepay the principal of the loan prior to its maturity date. This uncertainty in the consequences of a sale by petitioner of the Treasury obligations prior to their due date might have led the Tax Court to conclude that petitioner and her advisors could not have entertained a realistic hope of economic profit when these loan transactions were commenced. Finally, Exhibit 84 is predicated on the remote possibility that the Treasury obligations could be sold considerably in excess of par, thereby yielding an effective rate of interest well below 1½%, even though it would be unlikely that investors would purchase them for such a small return when they were to mature at par in the near future.

For all of the above reasons the Tax Court was justified in concluding that petitioner entered into the Jersey City Bank and Royal State Bank transactions without any realistic expectation of economic profit and "solely" in order to secure a large interest deduction in 1958 which could be deducted from her sweepstakes winnings in that year. This conclusion points the way to affirmance in the present case.

We hold, for reasons set forth hereinafter, that Section 163(a) of the 1954 Internal Revenue Code does not permit a deduction for interest paid or accrued in loan arrangements, like those now before us, that can not with reason be said to have purpose, substance, or utility apart from their anticipated tax consequences. See *Knetsch* v. *United States*, 364 U. S. 361, 366 (1960); *Diggs* v. *Commissioner*, 281 F. 2d 326 (2 Cir.), *cert. denied*, 364 U. S. 908 (1960); *Weller* v. *Commissioner*, 270 F. 2d 294, 297 (3 Cir. 1959), *cert. denied*, 364 U. S. 908 (1960).[5] Although it is by no means certain that Congress constitutionally could tax gross income, see Surrey & Warren, *Federal Income Taxation* 228-29 (1960 ed.), it is frequently stated that deductions from "gross income" are a matter of "legislative grace." E.g., *Deputy* v. *DuPont*, 308 U. S. 488, 493 (1940). There is at least this much truth in this oft-repeated maxim: a close question whether a particular Code provision authorizes the deduction of a certain item is best resolved by reference to the underlying Congressional purpose of the deduction provision in question.[6]

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5 We confine our discussion of transactions inspired by tax avoidance motives to those transactions inspired by the lure of Section 163(a)—a section that has proved to be the Internal Revenue Code's counterpart of the mythical Sirens of the Surrentine promontory. See *Minchin* v. *Commissioner*, 335 F. 2d 30 (2 Cir. 1964); *Jockmus* v. *United States*, 335 F. 2d 23 (2 Cir. 1964); *Dooley* v. *Commissioner*, 332 F. 2d 463 (7 Cir. 1964); *Lewis* v. *Commissioner*, 328 F. 2d 634 (7 Cir.), cert. denied, 379 U. S. 821 (1964); *Bridges* v. *Commissioner*, 325 F. 2d 180 (4 Cir. 1963); *Lynch* v. *Commissioner*, 273 F. 2d 867 (2 Cir. 1959); *Goodstein* v. *Commissioner*, 267 F. 2d 127 (1 Cir. 1959). These cases involve various unsuccessful efforts by taxpayers to claim Section 163(a) deductions for interest paid on indebtedness claimed by taxpayers to be genuine debts.

6 The proposition that because deductions are a matter of "legislative grace" they should be strictly construed is much more doubtful as an interpretative guide. See Note, An Argument Against the Doctrine That Deductions Should Be Narrowly Construed as a Matter of Legislative Grace, 56 Harv. L. Rev. 1142 (1943).

Admittedly, the underlying purpose of Section 163(a) permitting the deduction of "all interest paid or accrued within the taxable year on indebtedness" is difficult to articulate because this provision is extremely broad: there is no requirement that deductible interest serve a business purpose, that it be ordinary and necessary, or even that it be reasonable. 4 Mertens, *Law of Federal Income Taxation* §26.01 (1960 ed.). Nevertheless, it is fair to say that Section 163(a) is not entirely unlimited in its application and that such limits as there are stem from the Section's underlying notion that if an individual or corporation desires to engage in purposive activity, there is no reason why a taxpayer who borrows for that purpose should fare worse from an income tax standpoint than one who finances the venture with capital that otherwise would have been yielding income.

In order fully to implement this Congressional policy of encouraging purposive activity to be financed through borrowing, Section 163(a) should be construed to permit the deductibility of interest when a taxpayer has borrowed funds and incurred an obligation to pay interest in order to engage in what with reason can be termed purposive activity, even though he decided to borrow in order to gain an interest deduction rather than to finance the activity in some other way. In other words, the interest deduction should be permitted whenever it can be said that the taxpayer's desire to secure an interest deduction is only one of mixed motives that prompts the taxpayer to borrow funds; or, put a third way, the deduction is proper if there is some substance to the loan arrangement beyond the taxpayer's desire to secure the deduction. After all, we are frequently told a taxpayer has the right to decrease the amount of what otherwise would be his taxes, or altogether

avoid them, by any means the law permits. E.g., *Gregory* v. *Helvering*, 293 U. S. 465 (1935).[7] On the other hand, and notwithstanding Section 163(a)'s broad scope, this provision should not be construed to permit an interest deduction when it objectively appears that a taxpayer has borrowed funds in order to engage in a transaction that has no substance or purpose aside from the taxpayer's desire to obtain the tax benefit of an interest deduction: and a good example of such purposeless activity is the borrowing of funds at 4% in order to purchase property that returns less than 2% and holds out no prospect of appreciation sufficient to counter the unfavorable interest rate differential. Certainly the statutory provision's underlying purpose, as we understand it, does not require that a deduction be allowed in such a case. Indeed, to allow a deduction for interest paid on funds borrowed for no purposive reason, other than the securing of a deduction from income, would frustrate Section 163(a)'s purpose; allowing it would encourage transactions that have no economic utility and that would not be engaged in but for the system of taxes imposed by Congress. When it enacted Section 163(a) Congress could not have intended to permit a taxpayer to reduce his taxes by means of an interest deduction that arose from a transaction that had no substance, utility, or purpose beyond the tax deduction. See *Knetsch* v. *United States, supra*, at 367.

In many instances transactions that lack all substance, utility, and purpose, and which can only be explained on the ground the taxpayer sought an interest deduction in order to reduce his taxes, will also be so transparently arranged that they can candidly be labeled "shams." In

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7 This area of the law is particularly full of black-letter maxims that prove singularly unhelpful when it comes to deciding cases.

those instances both the rationale of the decision we announce today, and that of *Goodstein* v. *Commissioner, supra,* and its progeny, are available as grounds for disallowing the deduction. The present case makes plain, however, that these rationales are distinct from each other, and that a court need not always first label a loan transaction a "sham" in order to deny a deduction for interest paid in connection with the loan.

In *Knetsch* v. *United States, supra* at 365, the Supreme Court cautions us, by reiteration there of what the Court had said in *Gregory* v. *Helvering, supra* at 469, that in cases like the present "the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended." We here decide that Section 163(a) does not "intend" that taxpayers should be permitted deductions for interest paid on debts that were entered into solely in order to obtain a deduction. It follows therefore from the foregoing, and from the Tax Court's finding as a matter of "ultimate" fact that petitioner entered into the Jersey City Bank and Royal State Bank transactions without any expectation of profit and without any other purpose except to obtain an interest deduction, and that the Tax Court's disallowance of the deductions in this case must be affirmed.

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Supreme Court of the United States

OCTOBER TERM, 1966

No. 728

MAX BARNETT and ESTHER BARNETT,

Petitioners,

—against—

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

APPENDIX TO PETITION FOR A WRIT OF CERTIORARI

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Findings and Opinion of Tax Court

44 T. C. No. 28

TAX COURT OF THE UNITED STATES

MAX BARNETT AND ESTHER BARNETT,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE

Respondent.

Docket No. 92538 Filed May 28, 1965.

Taxpayer purportedly borrowed money from Gibraltar Financial Corporation to buy United States Treasury Certificates of Indebtedness. Gibraltar did not have the funds to loan to petitioner nor the certificates. Gibraltar arranged for the purchase of the certificates which were pledged as collateral with a bank to secure the bank's loan to Gibraltar, which funds were applied to the purchase. The certificates were sold by Gibraltar within 30 days and the proceeds of the sales were applied by Gibraltar in repayment of the bank's loan. *Held:* An amount paid by petitioner to Gibraltar in December 1957, designated as "prepaid interest" is not deductible under section 163(a), 1954 Code. As a payment of interest, the transaction between taxpayer and Gibraltar was a sham.

George V. Delson and *William P. Miller,* for the petitioners. *Lee A. Kamp,* for the respondent.

HARRON, *Judge:* Respondent determined a deficiency in income tax for 1957 in the amount of $16,189.36. The

question is whether petitioner is entitled to a deduction in 1957 of $30,850.49 under section 163(a), 1954 Code, as interest paid on indebtedness.

Findings of Fact.

Most of the facts have been stipulated. The stipulated facts are found accordingly.

Petitioners are residents of Merrick, New York. They filed a joint return for 1957 with the district director of internal revenue in Brooklyn, New York, on the basis of a calendar year and cash method of accounting. Since the issue relates only to Max Barnett, he is referred to herein as the petitioner.

Petitioners' 1957 return is signed by petitioners and, also, by Milton Zipper, as the person who prepared the return, and it bears a rubber stamp reading "Milton Zipper, Certified Public Accountant, 37 East Main Street, Oyster Bay, New York." Petitioners filed a joint return for 1958, a copy of which is in evidence, on which a rubber stamp is affixed with the notation, "Milton Zipper, C.P.A."

Petitioner did not appear at the trial of this case. He did not testify.

From the 1957 and 1958 returns, it is evident that Zipper is petitioners' accountant and that he prepared the returns. From several exhibits it is also evident that Zipper was known to Gibraltar, since in the account on the books of Gibraltar, opened on December 23, 1957, for the transaction in dispute, the name and style of the account is "Mr. Max Barnett, c/o Milt Zipper, Esquire, 37 Main Street [sic], Oyster Bay, New York."

Findings and Opinion of Tax Court

In 1957, petitioner received $50,000 as a prize as the winner of a contest conducted by a newspaper, the Journal American in New York City; he reported the $50,000 in income on his 1957 return.

Petitioner reported on his 1957 return, income from salary in the amount of $7,825, paid by a corporation, Island Radio Dist[ributor], Inc., Hempstead, New York. He reported on the 1957 return, adjusted gross income in the amount of $56,845, and taxable income of $18,847.71. Included in the deductions taken is $30,850.49. It was deducted as "interest" paid to Gibraltar. Respondent disallowed the claimed deduction of $30,850.49. The reason given in the deficiency notice is that "the amount does not represent interest within the purview of section 163 of the Internal Revenue Code of 1954 and that the transaction allegedly giving rise to said claimed deduction is a transaction lacking in substance." This determination of the respondent is in issue here.

On the 1957 return, petitioner deducted $1,500 as expense connected with the preparation of the return. Respondent disallowed the deduction, but he now concedes error and agrees that this deduction can be allowed.

Gibraltar, during the pertinent period was a dealer in municipal, state, and Federal bonds, having its offices in New York City. It maintained a checking account with Irving Trust Company (Irving Trust) in the same city. Irving Trust maintained on its books for Gibraltar a "securities clearance" account, which is defined in the stipulation of facts as one where

> a broker, acting without sufficient cash, may purchase stock or bonds and sell them almost immediately, making a profit or commission on the transaction. He is not able to pay for the security

purchase, and he, therefore, employs his bank or possibly some other broker to pay for and receive the same, and then make[s] delivery to the purchaser; the difference between the purchase and selling prices less the clearing charges to be paid to the first broker. At the time of purchasing, a broker may say to the seller, "Doe & Co. will clear for me", meaning that the seller is expected to make delivery to Doe & Co. for the broker's account; the broker, in the meantime, instructing Doe & Co. as to the transaction.

The assets, liabilities, and net worth of Gibraltar as of the end of its fiscal years ending on November 30, 1956, 1957, and 1958, were as follows:

	11/30/56	11/30/57	11/30/58
Assets			
Cash in banks	$ 24,401	$ 32,475	$ 65,202
Receivable*	69,599,555	61,551,150	56,506,071
Securities, Long	22,614,933	11,403,774	0
Other Assets	7,571	6,416	8,590
	$92,246,460	$72,993,815	$56,579,863
Liabilities			
Loans Payable**	$ 109,000	$ 91,800	$ 583,500
Accts. Payable	3,932	21,304	18,874
Securities Borrowed	92,214,703	73,010,967	56,299,601
Acc'd. Exp. Payable	17,825	0	0
Capital Stock	2,000	2,000	2,000
Deficit	(101,000)	(132,256)	(324,712)
	$92,246,460	$72,993,815	$56,579,863

* Notes and accounts receivable.
** Secured, payable to banks.

Findings and Opinion of Tax Court

On Friday, December 20, 1957, petitioner and Gibraltar entered into an arrangement whereby petitioner purportedly bought from Gibraltar and Gibraltar purportedly sold to petitioner on "margin" $750,000, face amount of 3¾ percent, short term, United States Treasury Certificates of Indebtedness (certificates) issued on November 26, 1957, and due on December 1, 1958; and on that date petitioner purportedly placed an order with Gibraltar to make that "purchase" for his new account, settlement date, December 23; and on that date Gibraltar mailed him a "sale confirmation" slip confirming a "sale" to him of the certificates at 100²³/₃₂ in the principal amount of $755,390.63, plus accrued interest for 22 days, from December 1, of $1,699.86, or a total of $757,090.49. An account was opened on Gibraltar's books in petitioner's name, care of Zipper, on December 23, 1957, designated "Special Loan", and under that date the account was "charged" with the "purchase" for the account of the certificates in the amount of $757,090.49. The arrangement (i.e., the steps that were taken) was that the "Special Loan" account was opened on Gibraltar's books to reflect a purported loan by Gibraltar to petitioner for the purchase of the certificates in the net amount of $747,890.63; petitioner gave Gibraltar his check for $9,199.86 as "margin"; he executed a promissory note payable to Gibraltar 9 months later in the above net amount, which recited that he deposited and pledged the certificates with Gibraltar as collateral security, and that it could repledge the collateral security; and he made a second payment to Gibraltar of $30,850.49, which purportedly was a "prepayment" of all of the "interest" on the note for 9 months. Thus, petitioner made 2 payments to Gibraltar totalling

$40,050.35. The details are set forth *infra*. However, on December 20 and 23, 1957, Gibraltar did not have its own cash in the amount of $757,090.49, or $747,890.63, and it did not have the certificates in its inventory.

On December 20, 1957, Gibraltar (hereinafter sometimes referred to as G) placed an order with The First Boston Corporation, a dealer in Government bonds, for the purchase of $750,000 of the certificates described above at the price of $100^{22}/_{32}$, to be delivered on Monday, December 23, to Irving Trust against payment; and G took the following additional steps on the same day: G sent a letter to The Cleveland Trust Company (Cleveland Trust) in Cleveland, Ohio, requesting that it should instruct its correspondent bank in New York City, the Chemical Corn Exchange Bank (Chemical), to receive on December 23 from Irving Trust the $750,000 of certificates for G's account, and to pay Irving Trust $740,000. G sent to Cleveland Trust, with the letter, G's promissory note for $740,000, payable on demand, bearing interest at the rate of 4 percent, and G requested Cleveland Trust to charge G's account for the cost of handling the transaction. G also sent a letter dated December 20, 1957, to Irving Trust, attention of its securities clearance department, to deliver on December 23 to Chemical against payment of $740,000, the $750,000 of certificates for G's account with Cleveland Trust. All of the instructions were carried out, as follows:

Boston mailed G its confirmation slip dated December 20, 1957, settlement date December 23, showing a sale to G of $750,000 certificates at the price of $100^{22}/_{32}$, in the principal amount of $755,156.25, plus 22 days' accrued interest $1,699.86, or a total price of $756,856.11, delivery

to be made to Irving Trust against payment of the total amount on December 23; and First Boston recorded the transaction on its books as a sale, and G recorded it on its books as a purchase. On December 23, 1957, First Boston, through its agent, Manufacturers Trust Company in New York City, delivered the certificates to Irving Trust, which paid $756,856.11 to First Boston through its agent. Irving Trust mailed to G its debit advice showing that it had received the certificates from First Boston for redelivery against payment of funds [to Chemical]; had charged G a clearance charge of $7.50; and had debited G's checking account in the amount paid First Boston, plus the clearance charge, or the total amount of $756,863.61. Irving Trust, on December 23, debited G's checking account in the latter amount.

On December 23, 1957, Irving Trust delivered the certificates to Chemical for the account of Cleveland Trust, and received $740,000 from Chemical. Irving Trust on that date credited G's checking account in the above amount, and it mailed its credit advice to G showing these details.

Pursuant to the above steps, G borrowed $740,000 from Cleveland Trust on December 23, 1957, at 4 percent interest, gave its promissory note for that amount, payable on demand, and pledged as collateral security for the loan the $750,000 of certificates. On its books, G recorded the receipt of $740,000 as "Loans Payable—Cleveland Trust."

The certificates delivered to Chemical were held at all times during the period of Cleveland Trust's loan in identical or equivalent form by Chemical as the corresponding bank of Cleveland Trust. Neither G, Cleveland Trust, nor Chemical sold short the certificates, pledged by G

with Cleveland Trust as security for the loan. It is customary for a correspondent bank to receive securities and hold them for an out-of-state bank, which is what Chemical did for Cleveland Trust in respect of the certificates in question.

On December 23, 1957, petitioner issued his check, payable to G in the amount of $9,199.86, which G received and deposited in its regular bank account. G credited the special loan account in petitioner's name (mentioned above) on its books on December 23 with the above amount. The credit left a debit balance in the account of $747,890.63. The above amount, computed by G, represented the accrued interest on the certificates from December 1 to 23, 1957, $1,699.86, plus $7,500, "one point 'margin' on the face value of the Treasury Certificates."

Petitioner executed a promissory note dated December 23, 1957, payable to G 9 months later, on September 23, 1958, in the amount of $747,890.63 (the amount of the debit balance in the special loan account on G's books in his name), which account purportedly reflected a loan by G to petitioner in the amount of the note. The note is incorporated herein by reference. The note is a typed, mimeographed, or printed form, on letter-size paper (8½ x 11 inches); certain details were inserted to fill in the blank spaces; and at the end, after petitioner's signature ("Max Barnett c/o Milt Zipper", with Zipper's address) 3 paragraphs were added. Opposite petitioner's signature is the rubber stamp of G marking the note paid, January 20, 1958. It is also marked "Accepted" by Irving Resnick, vice president of G. The note recites, inter alia, the following: Interest shall be charged at the rate of 5¾ percent per annum; that the undersigned (Barnett) deposits and

pledges with the Lender (G), as collateral security for the payment of the note, $750,000 face amount, 3¾ percent Treasury Certificates due December 1, 1958; that the Lender has the usual rights to sell the collateral security upon default in the payment of the note and take appropriate action to make collection; that the "Lender may repledge all or any of the collateral security for any sum not in excess of the amount due * * * at the date of such repledge with any person, firm or corporation for any purpose whatsoever"; and that the term "undersigned" shall mean, inter alia, "the heirs, executors, * * * or assigns thereof." The 3 paragraphs added at the end of the note are:

> Anything to the contrary herein contained notwithstanding, should the undersigned pay the total interest due hereunder within a period of thirty (30) days from the execution hereof, interest shall be charged at the rate of 5½% per annum; should the undersigned pay the total interest due hereunder after thirty (30) days from the execution hereof but prior to one hundred and twenty days from the execution hereof, interest shall be charged at the rate of 5⅝% per annum.
>
> The undersigned has the right to prepay principal at any time and in any amount with the exception however that the minimum interest payable hereunder shall be for a period of thirty (30) days on the total principal indebtedness.
>
> Anything to the contrary herein contained notwithstanding, the lender shall not have the right to demand additional collateral unless and until the

market value of the securities pledged hereunder shall be less than one point below the principal debt hereunder.

With respect to the payment and rate of interest under the note: There is no provision therein fixing a date or dates when interest shall become due and payable other than the due date of the note, September 23, 1958, 9 months after the date of execution. The 5¾ rate of interest is subject to reduction to either 5½ or 5⅝ percent, depending upon the maker's permissive election to prepay all of the 9 months' interest on the principal amount either within 30 days from the date of execution, or after 30 days but before 120 days from the execution date. The principal amount of the note may be prepaid at any time and in any amount prior to the due date, but regardless of the date and amount of any prepayment of principal, there is a "minimum" charge for "interest" equal to interest on the principal amount for 30 days at whichever rate of interest applies at the time of the payment of such "minimum amount of interest."

On December 26, 1957, petitioner paid G $30,850.49, under his check of that date, which amount purportedly was a prepayment of "interest" at the rate of 5½ percent of $747,890.63, the principal amount of the promissory note. G deposited this amount in its checking account with Irving Trust on the same date.[1] G did not credit this payment to the "special loan" account mentioned above. Rather, G credited it to some other account on

1. This deposit is shown by the bank statement for that account (exhibit 18-R). Paragraph 8 of the stipulation of facts may be in error, to the effect that G deposited this amount in its "regular" bank account. See i.e., paragraph 6 of the stipulation.

its books and recorded the payment as "interest income." As is set forth *infra*, G refunded the total sum of $27,423.06 to petitioner in January 1958 in 2 payments. The payment on December 26, 1957, of $30,850.49 is the item in issue which petitioner deducted in his 1957 return as a payment of "interest", which deduction was not allowed by respondent.

The following schedule sets forth the range of the high and low prices at which the 3¾ percent certificates due December 1, 1958, were traded during the period November 26, 1957, to November 26, 1958:

Dates	High Bid	Low Bid
Nov. 26, 1957	100 6/32	—
Dec. 1957	100 26/32	100 8/32
Jan. 1958	101 5/32	100 26/32
Feb. 1958	101 19/32	101 8/32
Mar. 1958	101 19/32	101 14/32
Apr. 1958	101 22/32	101 16/32
May 1958	101 18/32	101 16/32
June 1958	101 17/32	101 3/32
July 1958	101 3/32	100 29/32
Aug. 1958	100 28/32	100 10/32
Sept. 1958	100 10/32	100 5/32
Oct. 1958	100 6/32	100 5/32
Nov. 1958 (to Nov. 26, 1958)	100 5/32	99 30/32

On January 2, 1958, settlement date January 3, G placed an order with C. J. Devine & Co. (Devine), a dealer in Government bonds, to sell $250,000 of the certificates at the price of 100-26/32, and to receive them from Irving

Trust; and on January 2, G sent a letter to the securities clearance department of Irving Trust instructing it to pay Chemical $250,000 and receive from Chemical the $250,000 of certificates; all of which was done. Also, on January 2, 1958, settlement date January 3, G sent petitioner a confirmation advice advising him that G had "purchased" from him $250,000 certificates at the price of 100-25/32 (not 100-26/32) with accrued interest from December 1, 1957 to January 3, 1958, the details of which are stated later. The next business day after January 3 was January 6.

The steps taken by Irving Trust, as shown by its advices to G, were as follows: Devine sold the $250,000 certificates at 100-26/32 for the principal amount of $252,031.25, plus accrued interest of $849.93, or a total amount of $252,881.18. Irving Trust, on January 6, debited G's checking account in the amount of $250,002.50, which included its clearance charge of $2.50, paid $250,000 to Chemical for the account of Cleveland Trust and received the certificates, and delivered them to Manufacturers Trust for Devine against payment of $252,881.18, which amount Irving Trust credited to G's checking account on January 6, and so advised G.

In the "special loan" account in petitioner's name on G's books, under date of January 3, 1958, G credited the account in the amount of $252,803.06, representing $251,953.13, at the price of 100-25/32, plus accrued interest from December 1, 1957, to January 3, 1958, of $849.93. These details were stated in G's confirmation advice to petitioner dated January 2, 1958.

G mailed to petitioner its "not negotiable" check dated January 3, 1958, for $3,506.18 and charged that amount

to the "special loan" account on its books in petitioner's name. The computation of the amount is explained (in effect) on the voucher of G's check, as follows: $439.56 was the difference between the amount credited to the account as the proceeds from G's "purchase" from petitioner of $250,000 of certificates for the total amount of $252,803.06, and the "cost" allocated by G to them of $252,363.50; and G refunded $3,066.62, one-third of $9,199.86, the so-called "original margin". The total of the 2 amounts is $3,506.18.

G also mailed peittioner a "not negotiable" check dated January 3, 1958, for $9,140.89, which was a refund of part of the $30,850.49, which petitioner had paid to G on December 26, 1957. On the voucher of the check G explained the computation of the amount. In substance it was: G allocated to the $250,000 principal amount of certificates, one-third of $30,850.49, or $10,283.50, G computed, with respect to $250,000 of certificates, as the "30 day minimum as per loan agreement", $1,142.61, which G retained. G refunded to petitioner, out of $10,283.50, the sum of $9,140.89. It is stipulated that such amount ($9,140.89) was recorded on the books of Gibraltar (in some other account than the one in petitioner's name) as refund of "interest" previously "prepaid" by petitioner. G retained $20,566.99 out of the $30,850.49.

On January 17, 1958, settlement date January 20, 1958, G placed an order with Devine to sell $500,000 of the certificates at 101-2/32, and to receive them from Irving Trust; and G sent a letter to Cleveland Trust and another letter to the securities clearance department of Irving Trust, each dated January 17, 1958, giving instructions about the delivery of the certificates to Irving Trust. G

first telephoned Ralph Holah at Cleveland Trust, in Cleveland, about the directions; the letter confirmed the oral directions. G instructed Cleveland Trust to direct Chemical to deliver to Irving Trust on January 20, 1958, $500,000 face amount of the certificates against payment of $490,000, to be credited to G's loan account with Cleveland Trust, which would constitute payment of the balance of Cleveland's demand loan to G in the amount of $740,000, made on December 23, 1957. In the letter to Irving Trust, G instructed it to receive for G's account the $500,000 of certificates and to pay Cleveland $490,000. These directions were carried out. G sent petitioner a confirmation dated January 17, 1958, settlement date January 20, 1958, advising him that it had "purchased" from him $500,000 of the certificates at 101 (not 101-2/32) with accrued interest from December 1, 1957, to January 20, 1958, the details of which are stated later.

The steps taken by Irving Trust, as shown by its advices to G, were as follows: Devine sold the $500,000 certificates at 101-2/32 for the principal amount of $505,078.13, plus accrued interest of $2,575.55, or a total amount of $507,653.68. Irving Trust on January 6, 1958, debited G's checking account in the amount of $490,005 (which included its clearance charge of $5 and paid $490,000 to Chemical for the account of Cleveland Trust, received the certificates and delivered them to Manufacturers Trust for Devine against payment of $507,653.68, which amount Irving Trust credited to G's checking account on January 20, 1958, and so advised G.

In the "special loan" account in petitioner's name on G's books, under date of January 20, 1958, G credited the account in the amount of $507,575.55, representing the

principal amount of $505,000, at the price of 101, plus accrued interest from December 1, 1957, to January 20, 1958, of $2,575.55. These details were stated in G's confirmation advice to petitioner dated January 17, 1958.

G mailed petitioner its "not negotiable" check dated January 20, 1958, in the amount of $8,981.80, and charged the same amount to the "special loan" account on its books in petitioner's name. The only explanation on the voucher of the check is "Balance due on trading account."

The detailed explanation of G's computation of the above amount is stated below, and may be understood by referring to the voucher of G's check to petitioner dated January 3, 1958, mentioned above, by which G paid petitioner $3,506.18. Prior to making the payment of $8,981.80 to petitioner, the account on G's books showed a credit balance in his favor of $8,981.80, after the credit of $507,575.55 on January 20. The payment to petitioner of $8,981.80 served to close the account, as the following shows:

Dates	Charges	Credits	Debit Balance	Credit Balance
12/23/58	$757,090.49	$ 9,199.86	$747,890.63	—
1/ 3/58	3,506.18	252,803.06	498,593.75	—
1/20/58	—	507,575.55	—	$8,981.80
1/20/58	8,981.80	—	—	—

Petitioner had paid G on December 23, 1957, the amount of $9,199.86. By its check for $3,506.18, on January 3, G refunded $3,066.62 of that amount and had retained the difference in the amount of $6,133.24. By its check dated January 20 in the amount of $8,981.80, G refunded $6,133.24 to petitioner, and paid him, in addition, the

amount of $2,848.56, which represented the difference between the proceeds of $507,575.55, which was credited to the account as the proceeds of G's purported "purchase" of $500,000 of the certificates from petitioner, and a "cost" allocated to them by G in the amount of $504,726.99.

G also sent petitioner a second check dated January 20, 1958, in the amount of $18,282.17, which represented a refund of $18,282.17 out of the $30,850.49 which petitioner had paid G on December 26, 1957. On the voucher of this check, G gave the following explanation, in effect, of its computation (which, however, contains 2 incorrect figures; the errors are corrected in the following explanation): G allocated to the $500,000 principal amount of certificates two-thirds of $30,850.49, or $20,566.99. G computed as the "30 day minimum as per loan agreement" $2,284.82, which G retained. G refunded to petitioner $18,282.17, the difference between the 2 latter figures above. It is stipulated that the $18,282.17 was recorded on the books of Gibralter [in some account other than the one in petitioner's name] as a refund of "interest" previously "prepaid" by petitioner.

The following details and schedules summarize the several steps which made up the transaction between petitioner and G, and G's handling of the whole matter:[2]

2. The parties submitted as part of the stipulation of facts many documents which are copies of Gibraltar's records. However, they did not in their stipulation of facts provide the Court with the breakdown of many figures appearing in certain exhibits, which they could have done, and in the absence of their doing so, the Court has made the analyses and break-downs of certain figures which, for clarity and accuracy, are necessary. Furthermore, in paragraph 31 of the stipulation of facts there are obvious errors in certain figures. They have been corrected by the Court; the correct figures are indicated by certain exhibits.

In the special account in petitioner's name on G's books, the initial charge to the account was in December 1957 for $750,000 face amount of certificates, but in January 1958 G disposed of them in 2 lots of $250,000 and $500,000. In order to obtain certain figures which entered into some of the credits to the account in 1958 and checks of G to petitioner, it is necessary to break down total figures to obtain for each lot of certificates the principal amount and the interest which had accrued on them at the time of acquisition in December 1957. G charged the special account on December 23, 1957, $757,090.49, representing the principal amount of $755,390.63, plus interest accrued from December 1 to December 23, 1956, of $1,699.86. The 2 latter figures are broken down to show the charges per books to the special account for the principal amounts of $250,000 and $500,000 of certificates and the interest accrued on each principal amount:

Certifs.	Price	Principal Amount	Accrued Int. to 12/23/57	Total
$250,000	100²³⁄₃₂	$251,796.88	$ 566.62	$252,363.50
500,000	100²³⁄₃₂	503,593.75	1,133.24	504,726.99
$750,000	100²³⁄₃₂	$755,390.63	$1,699.86	$757,090.49

G disposed of $250,000 of certificates and with respect thereto credited on January 3, 1958, to the special account, $252,803.06 representing the principal amount (at 100²³⁄₃₂) of $251,953.13, plus interest accrued from December 1, 1957, to January 3, 1958, in the amount of $849.93. The following shows the "gain" and the interest which accrued

on those certificates between December 23, 1957, and January 3, 1958:

1/ 3/58	Principal amt. credited by G	$251,953.13
12/23/57	Principal amt. charged by G	251,796.88
1/ 3/58	Net. amt. credited as "gain"	$ 156.25
1/ 3/58	Interest accrued 12/ 1/57 to 1/ 3/58	$ 849.93
12/23/57	Interest accrued 12/ 1/57 to 12/23/57	566.62
1/ 3/58	Increase in acc'd. int. credited	$ 283.31

G's check to petitioner and credit to the account on January 3, 1958, included $439.56, consisting of "gain" of $156.25, plus accrued interest of $283.31.

G disposed of $500,000 of certificates and credited the special account on January 20, 1958, with $507,575.55, representing the principal amount of $505,000 (at 101), plus interest accrued from December 1, 1957, to January 20, 1958, in the amount of $2,575.55. The following shows the "gain" and the interest which accrued on these certificates between December 23, 1957, and January 20, 1958, as credited to the special account:

1/20/58	Principal amt. credited by G	$505,000.00
12/23/57	Principal amt. charged by G	503,593.75
1/20/58	Net am. credited as "gain"	$ 1,406.25
1/20/58	Interest accrued 12/ 1/57 to 1/20/58	$ 2,575.55
12/23/57	Interest accrued 12/ 1/57 to 12/23/57	1,133.24
1/20/58	Increase in acc'd. int. credited	$ 1,442.31

G's check to petitioner and the credit to the account on January 20, 1958, included $2,848.56, consisting of "gain" of $1,406.25, plus accrued interest of $1,442.31.

According to the credits made by G to the special account in 1958 with respect to the $750,000 of certificates, the total amounts credited thereto as "gain", and as interest accrued on each lot of certificates from December 23, 1957, to January 3 and 20, 1958, respectively, were:

	"Gain"	Accrued Interest	Total
$250,000	$ 156.25	$ 283.31	$ 439.56
500,000	1,406.25	1,442.31	2,848.56
Total	$1,562.50	$1,725.62	$3,288.12

G refunded to petitioner in 2 payments in January 1958 all of the deposit of $9,199.86 which he made on December 23, 1957, namely, $3,066.62, on January 3, tand $6,133.24 on January 20. These refunds were "charges" to the special account. The following shows the breakdowns of the charges and the credits to the special account relating to the foregoing:

Dates	Items	Credits and Paid In	Charges for Paid Out
12/23/57	Deposit	$ 9,199.86	—
1/ 3/58	Refund		$ 3,066.62
1/20/58			6,133.24
1/ 3/58	"Gain"	156.25	156.25
1/20/58	"Gain"	1,406.25	1,406.25
1/ 3/58	Accrued Int.	283.31	283.31
1/20/58	Accrued Int.	1,442.31	1,442.31
		$12,487.98	$12,487.98

Petitioner paid G on December 26, 1957, $30,850.49 as a "prepayment" under his note of "interest" for the 9-month

period from December 23, 1957, to the date stated thereon as the "due date," September 23, 1958. G made refunds to petitioner of $9,140.89 and $18,282.17, or the total sum of $27,423.06; and G retained $3,427.43 as the 30-day minimum charge, i.e., $1,142.61, from December 23, 1957, to January 3, 1958, and $2,284.82, from December 23, 1957, to January 20, 1958:

Dates	Item	Credit Paid to G	Refund	Charged by G
12/26/57	"Prepayment"	$30,850.49	—	—
1/ 3/58	Refund & Charge		$ 9,140.89	$ 1,142.61
1/20/58	Refund & Charge		18,282.17	2,284.82
		$30,850.49	$27,423.17	$ 3,427.43

G charged petitioner as "interest" in 1958, a 30-day minimum charge at 5½ percent on the principal amount of $747,890.63, the sum of $3,427.43. G credited to the special account and paid petitioner $3,288.12 (short-term capital gain, $1,562.50, plus interest accrued on the certificates during the periods involved in the transaction, $1,725.62):

Charged by G in 1958 as 30-day minimum	$3,427.43
Credited by G and paid to petitioner	3,288.12
Petitioner's expense	$ 139.31

Petitioner was out-of-pocket $139.31 when the special account on G's books was closed on January 20, 1958, as the result of the transaction.

Since all of the certificates were with Chemical for the account of Cleveland Trust during all of the time involved

in the whole transaction, neither G nor petitioner collected and received any of the interest that accrued on them under any payment by the United States Treasury Department; the certificates were acquired from First Boston and subsequently acquired by Devine as certificates having accrued interest. The amounts representing accruals of interest on the 2 lots ($250,000 and $500,000) were reflected in the payments to First Boston and the payments by Devine; which amounts were reflected in the respective debits and credits to the checking account of G on the books of Irving Trust; and, in turn, were reflected in the charges and credits by G to the special account on its books in the name of petitioner; and G included the amounts set forth above for interest accrued on the certificates in 2 checks payable to petitioner. In this way petitioner received $1,725.62 purportedly as interest on the certificates which accrued during each period that Chemical held $250,000 and $500,000 of the certificates.

In the return filed for 1958, petitioner reported two items as "interest" income, and an amount as short-term capital gain on the "sale" of $750,000 face amount of certificates: He reported incorrectly as "income from interest" (p. 3 of the return, Schedule B), as the amount which G refunded out of the $30,850.49, the sum of $27,263.97. Actually, G had refunded $27,423.06. He reported in addition, as income from interest, $1,725.62, which G had paid him as interest accrued on the certificates.[3] And he reported as short-term capital gain from

3. In paragraph 31 of the stipulation of facts, the parties incorrectly stated that the total amount of interest income reported for the 2 items was $29,989.59. The correct figure, per the return, is $28,989.59.

the "purchase" and "sale" of the certificates, the amount of $1,562.50, the total of G's credits to the special account, which was paid to petitioner.

The evidence does not show exactly what the nature of Gibraltar's business was in December 1957 and January 1958, or what it is in general, or the scope and variety of its services and transactions to all and various customers. The parties, in their stipulation of facts, have referred to a case decided by this Court, *Gordon MacRae*, 34 T.C. 20 (1960), affirmed on the same type of issue as is involved here, 294 F. 2d 56 (C.A. 9, 1961), certiorari denied 368 U.S. 955 and 1005, where certain transactions of Gibraltar in 1953 are described (pp. 22-26), and it is found (p. 22) that "All 'loans' on Gibraltar's books" during the period involved in that case "arose through transactions similar to those of petitioner [MacRae]." The parties have stipulated (par. 35) that "Gibraltar engaged in a substantial number of transactions similar to the type described in *Gordon MacRae*, 34 T.C. 20 (1961 [*sic*])."

Gibraltar is not a member of the New York Stock Exchange or any stock exchange.

The $750,000 face amount of certificates were not purchased in petitioner's name; they were purchased in Gibraltar's name; and when they were sold in January 1958, they were sold in Gibraltar's name.

Gibraltar never actually or physically had in its inventory or possession any of these certificates. They passed from one correspondent bank to another, each bank being an agent. They were held by Chemical Corn Exchange Bank in New York City, the correspondent bank of Cleveland Trust; and Chemical Corn Exchange delivered them to Manufacturers Trust Company in New York, the

agent of C. J. Devine & Co., when they were sold by Devine in January 1958. Gibraltar never received any of the interest which accrued on the certificates.

Petitioner was not known personally by any officer of Gibraltar. Milton Zipper, his accountant, made all of the arrangements with Gibraltar which are involved in the issue here.

Gibraltar prepared the 9-months' note dated December 23, 1957, which was signed by petitioner, "Max Barnett, c/o Milt Zipper." That note was not endorsed by any endorser for petitioner. There is no evidence to the effect that Gibraltar ever looked into petitioner's net worth and financial responsibility.

Petitioner did not have any contacts with Cleveland Trust with respect to a loan by that bank. Gibraltar frequently obtained loans from Cleveland Trust. Gibraltar made all of the arrangements for Cleveland Trust's loan to Gibraltar of $740,000 on December 23, 1957. Cleveland Trust did not refund any money to petitioner in connection with the transaction involved here.

Ultimate Findings of Fact.

Petitioner did not have any control at any time over the $750,000 of certificates.

Petitioner has failed to prove that at any time he exercised control over the whole transaction with Gibralter or any part thereof.

Zipper took into account the income tax advantages to petitioner of the arrangements which Zipper made with Gibralter, which are in issue here.

Petitioner has failed to prove that the arrangements with Gibraltar, as far as he was concerned, amounted to

anything more than a paper transaction evidenced by bookkeeping entries on Gibraltar's books.

Petitioner has failed to prove that the arrangements with Gibraltar had any substance and bona fides apart from providing the basis for a purported prepayment of purported interest on December 26, 1957, for income tax purposes.

As a payment of interest, the transaction of petitioner with Gibraltar was a sham. Petitioner did not pay interest on indebtedness to Gibraltar on December 26, 1957, in the amount of $30,850.49, within the meaning of section 163(a).

Petitioner did not have any out-of-pocket expenses in 1957 in connection with the transaction with Gibraltar. Such out-of-pocket expenses as eventually occurred in that transaction, in the net amount of $139.31, occurred in 1958. Such expenses were not incurred in a transaction entered into for profit.

OPINION.

The question is whether the sum of $30,850.49, which petitioner paid to Gibraltar on December 26, 1957, comes within the scope of section 163(a), 1954 Code,[4] as interest paid on indebtedness and, therefore, is deductible.

The respondent disallowed the deduction on the ground, as stated in the deficiency notice, that the transaction allegedly giving rise to the claimed deduction was a transaction lacking in substance and that the amount paid to Gibraltar does not represent interest within the purview of section 163(a).

4. SEC. 163. INTEREST.

(a) General Rule.—There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

Respondent contends that the purported loan by Gibraltar to petitioner of $747,890.63 was a sham; that as between Gibraltar and petitioner the whole transaction was a paper transaction of the Livingstone type (*Eli D. Goodstein,* 30 T.C. 1178, affd' 267 F. 2d 127); and that upon the record here the payment of $30,850.49 in December 1957 was part of a sham transaction, and that payment cannot be recognized for tax purposes as interest paid on indebtedness within the meaning and scope of section 163(a).

Respondent relies on the following: *Joseph H. Bridges,* 39 T.C. 1064 (1963), affd. 325 F. 2d 180; *Knetsch* v. *United States,* 364 U. S. 361 (1960); *Goodstein* v. *Commissioner,* 267 F. 2d 127, affirming 30 T.C. 1178; *MacRae* v. *Commissioner,* 294 F. 2d 56, affirming in part 34 T.C. 20; *Danny Kaye,* 33 T.C. 511, affd. 287 F. 2d 40; *J. George Gold,* 419 T.C. 419; *Lynch* v. *Commissioner,* 273 F. 2d 867; affirming 31 T.C. 990, and *Leslie Julian,* 31 T.C. 998; *Morris R. DeWoskin,* 35 T.C. 356; *Rubin* v. *United States,* 304 F. 2d 766. He relies, also, upon principles established by *Deputy* v. *DuPont,* 308 U. S. 488, and *Griffiths* v. *Helvering,* 308 U. S. 355.

Respondent does *not* concede in this case that the transaction between Gibraltar and petitioner was real, valid, and bona fide, cf. *L. Lee Stanton,* 34 T.C. 1, 7, 11, and argues that *Stanton* on its facts is distinguishable.

Petitioner relies on the form of the transaction and contends that the same result should be reached here as was reached in *Stanton, supra.*

Petitioner contends that the transaction with Gibraltar was not a sham transaction, but was a bona fide one in which the petitioner, on December 20, 1957, purchased

from Gibraltar $750,000 face amount of United States Treasury Certificates on margin, paying $9,199.86 as margin, and thereafter sold them to Gibraltar, $250,000 on January 2, 1958, and $500,000 on January 17, 1958, using the proceeds of the sales to pay his note to Gibraltar.

Petitioner admits that his desire to reduce his income taxes was a substantial factor in his paying $30,850.49 to Gibraltar on December 26, 1957, which he contends represented prepaid interest for 9 months on the note due in 9 months that he gave to Gibraltar in the amount of $747,890.63, but he argues that his tax-saving motive cannot be the basis for disallowing the deduction claimed as a deduction for interest.

This Court recognizes and agrees that a taxpayer has the right to decrease what would otherwise be his taxes by means which the law permits. This concept has been recognized by courts generally since at least *Gregory* v. *Helvering, supra.* But the *Gregory* case, as well as others cited herein, requires that the reduction be accomplished by means which the statute intended to provide. *Knetsch* v. *United States, supra.* In *Joseph H. Bridges, supra,* pp. 1075-1076, we said:

> Thus, the determination of whether petitioner's claimed deductions fall within the ambit of the statutory provision requires that we first look beyond the form in which petitioner cast the transactions to see "whether what was done, apart from the tax motive, was the thing which the statute intended." *Gregory* v. *Helvering, supra; Knetsch* v. *United States, supra; Amor F. Pierce,* 37 T.C 1039 (1962), affirmed per curiam 311 F. 2d 894 (C.A. 9, 1962); *Perry A. Nichols,* 37 T.C. 772 (1962), affirmed per curiam 314 F. 2d 337 (C.A. 5, 1963).

> Neither the labels which the parties have assigned to the payments nor the bookkeeping entries in their records are conclusive on this point. *George G. Lynch*, 31 T.C. 990 (1959), affd. 273 F. 2d 867 (C.A. 2, 1959).

See, also, *J. George Gold, supra*, 426-427.

Respondent's determination is prima facie correct. Petitioner had the burden of proving that it is in error. Petitioner's burden involved proving that the payment in issue, $30,850.49, constituted interest on indebtedness within the meaning of section 163(a).

A careful analysis of the whole record and of the transaction between Gibraltar and petitioner convinces us that petitioner has failed to establish that the payment in issue made by petitioner to Gibraltar was, in fact, interest within the meaning of section 163(a). In analyzing the transaction for this purpose, we have considered it from its inception in December 1957, until it was closed about 30 days later in January 1958, as we believe must be done to arrive at a correct conclusion. See *Joseph H. Bridges, supra*, p. 1076; and *Gordon MacRae*, 34 T.C. 20, 26, affirmed in part 294 F. 2d 56, *supra*, where we held (in another sort of transaction of a taxpayer with Gibraltar) that the transaction must be considered as a whole: "But we may not thus fragmentize the transactions here under consideration and view each step thereof as though independent of those which went before and those which followed."

We find the instant proceeding indistinguishable in principle from an ever lengthening line of decisions reaching like results in a variety of situations comparable to the one before us. See *J. George Gold, supra*, p. 427, and the

21 cases cited there, which includes those already cited hereinbefore and the following: *Broome* v. *United States*, 170 F. Supp. 613 (Ct. Cl.); *Weller* v. *Commissioner*, 270 F. 2d 294 (C.A. 3), affirming 31 T. C. 33 and *W. Stuart Emmons*, 31 T. C. 26, certiorari denied 364 U. S. 908; *Becker* v. *Commissioner*, 277 F. 2d 146 (C.A. 2), affirming a Memorandum Opinion of this Court; *United States* v. *Roderick*, 290 F. 2d 823 (C.A. 5); *Sonnabend* v. *Commissioner*, 267 F. 2d 319 (C.A. 1), affirming per curiam a Memorandum Opinion of this Court; *Egbert J. Miles*, 31 T.C. 1001; *Empire Press, Inc.*, 35 T.C. 136; and *William R. Lovett*, 37 T.C. 317. Except for immaterial variances as to names, amounts, the securities, and the forms of the transactions, this case comes within the principle of the cited authorities, and the holding in those cases that the transaction was a sham with respect to the purported payment of interest is controlling here. In *Knetsch* v. *United States*, *supra*, it was held that amounts claimed as "interest" could not be deducted where the transaction which gave rise to the claimed deduction was a sham. *Morris R. DeWoskin*, *supra*, p. 362.

The record fails to establish that petitioner actually borrowed $747,890.63 from Gibraltar, or actually purchased $750,000 face amount of Treasury Certificates. Although there were such amounts of identifiable certificates, they were never in the actual possession of Gibraltar and the evidence does not show that petitioner ever acquired any ownership of or control over such certificates for a period of a moment. The various documents in evidence merely give a misleading appearance of a purchase of the certificates by petitioner. Looking through the form and facade of the instruments themselves, there is no more

than Gibraltar's bookkeeping entries, as far as petitioner was concerned. The certificates found themselves in the hands of Chemical Corn Exchange Bank in New York, the correspondent bank and agent of Cleveland Trust, and later in the hands of Manufacturers Trust Company in New York, the correspondent bank and agent of Devine & Co. The money used to acquire the certificates on the market belonged to Cleveland Trust, which made funds available for a short time, altogether less than and not more than 30 days. Irving Trust acted as a clearance agent for the usual fee. The certificates were held for the account of Cleveland Trust by Chemical to secure Cleveland Trust's funds, and Cleveland Trust received its funds out of the proceeds of the disposition of the certificates. Gibraltar, the alleged lender of funds to petitioner, had no money and it did not forbear or permit the use of its money as a result of the round robin in which the banks, Cleveland Trust and Irving Trust, engaged. Cf. *Broome* v. *United States*, *supra*; *Lynch* v. *Commissioner*, *supra*.

To be sure, each of the steps set in motion by Gibraltar, carried out by Irving Trust and Cleveland Trust, which had no dealings with petitioner, if viewed separately, constituted normal business activities, similar to many real and substantial transactions consummated on any given business day. But we may not breathe life into the whole lifeless and unfragmentized transaction between petitioner and Gibraltar by transfusing it with the activities of the banks in their separate transactions. We cannot regard the whole transaction, as constructed by Gibraltar for petitioner's benefit, as one which consisted only of the steps followed by the banks (real enough in themselves

as separate steps), and fail to take into account the steps followed by Gibraltar and petitioner before and after the steps taken by the banks. Using the analysis made by this Court of a similar plan in *Gordon MacRae, supra,* p. 27, in the context of the whole transaction between Gibraltar and petitioner, the steps taken by the banks, each in itself a legitimate commercial operation, were but "mirror images" which added up to zero as far as petitioner was concerned. The method and form used by Gibraltar in the instant case was a method of doing nothing more than to erect the facade on which petitioner now relies.

In form, petitioner executed a note in Gibraltar's favor purporting to obligate himself to pay Gibraltar $747,890.63, and "interest". The note recited that he had purportedly deposited and pledged $750,000 face amount of certificates with Gibraltar as of December 23, 1957. As of that date, the certificates had a market value of $756,856.11, including the then accrued interest on the certificates. This purported note was not evidence of any real personal obligation of petitioner. The certificates themselves, which neither petitioner nor Gibraltar ever had, were the security for the funds used by the banks in their dealings. Certainly the transaction as set up on Gibraltar's books, including the formal note prepared by Gibraltar, merely provided the facade of a loan, and so far as petitioner was concerned the transaction did "not appreciably affect his beneficial interest," *Gilbert* v. *Commissioner,* 248 F. 2d 399 (dissenting opinion); *Bridges* v. *Commissioner, supra,* p. 184; *Knetsch* v. *United States, supra,* except to reduce his cash by the net amount of $139.31, and reduce his tax. *Joseph H. Bridges,* 39 T.C. 1064, 1077, *supra.*

Nor does the fact that petitioner deposited some cash with Gibraltar, $9,199.86 on December 23, 1957, and

$30,850.49 on December 26, 1957 (all of which was refunded to him except $139.31), provide the necessary substance for the whole transaction with Gibraltar. In *Deputy* v. *DuPont, supra,* it was pointed out by the Supreme Court that "although an indebtedness is an obligation, an obligation is not necessarily an 'indebtedness' within the meaning of section 23(b) [the statute]. • • • Nor are all carrying charges 'interest'." What was intended by section 163(a) was to create a deduction for interest paid or accrued on *indebtedness — genuine* indebtedness. Here there was no real purchase of certificates *by petitioner* and no genuine indebtedness of petitioner to Gibraltar. Bookkeeping entries, although evidence of transactions they purport to record, are not conclusive. *Doyle* v. *Mitchell Bros., Co.,* 247 U. S. 179; *Lynch* v. *Commissioner, supra,* pp. 871-872; *Malden Knitting Mills,* 42 T.C. 769; *Bornstein* v. *Commissioner,* 334 F. 2d 779.

Petitioner seeks to distinguish the instant transaction with Gibraltar as a "margin transaction," contending that petitioner put up a 1-point margin of $7,500, plus accrued interest on the certificates of $1,699.86, or a total of $9,199.86; and he argues that the other aspects of the transaction with Gibraltar, namely, the pledging of the certificates as collateral for the balance of the purchase price were the same as in the ordinary transaction involving a purchase of securities on margin. It must not be overlooked that the burden of proof is upon petitioner, and we will not assume facts in his favor without satisfying evidence, particularly in circumstances such as those disclosed by this record. *J. George Gold, supra,* p. 426. Cf. *Carl Shapiro,* 40 T.C. 34, 39. There is no evidence whatsoever in the record before us to support the conten-

tion that the transaction with Gibraltar constituted a bona fide margin transaction in Treasury Certificates, other than the self-serving designation by Gibraltar of the payment of $9,199.86 as "margin."

It is generally known that the purchase of securities on margin is subject to specific regulation prescribed by particular stock exchanges and the Securities and Exchange Commission (SEC), and that such regulations vary depending upon various factors. Gibraltar, in the period involved here, was not a member of the New York Stock Exchange or any other stock exchange, and as far as the record here shows, it was not subject to any such regulations. Its business operations included that of the services of a money broker, and it had established relations with banks out of New York City, such as Cleveland Trust, for obtaining funds from them for various purposes. Gibraltar resorted to its money broker contact with Cleveland Trust in Gibraltar's transaction with petitioner, but there is no evidence that Gibraltar's arrangements as between itself and petitioner constituted in fact a real and bona fide margin transaction. No one from Cleveland Trust testified and there is nothing in the record to show what the limits might have been, or the reasons for them, respecting the amount of money Cleveland Trust would or could have made available in the arrangements with Gibraltar respecting the certificates which immediately came under Cleveland Trust's control. Absent proof respecting the allegation that the Gibraltar-petitioner transaction was a real and bona fide margin purchase of certificates *by petitioner*, and in the context of the entire record in this case, the contention that it was a "margin" transaction must be rejected as without merit. Upon the whole record, this

detail of a cash deposit by petitioner, all of which was refunded within 30 days, is merely part of the form and framework devised by Gibraltar, which we have concluded was, with respect to the claimed interest deduction, a sham.

A careful weighing of the evidence convinces us that there was no genuine indebtedness established between petitioner and Gibraltar. Despite his assertion that he was borrowing close to three-fourths of a million dollars from Gibraltar, no officer or employee of Gibraltar ever met or talked with petitioner. As between Gibraltar and Cleveland Trust, we believe it is clear that the bank looked to the Treasury Certificates (and not to Gibraltar or a customer of Gibraltar as a purported "debtor") to recover funds which had been supplied by Cleveland Trust to acquire the certificates.

In the transaction between petitioner and Gibraltar, Gibraltar provided the service of providing the color and form for petitioner's claim for a deduction for alleged interest, and received a "commission" for its services. The commission, which is customary, was represented by differentials fixed by Gibraltar in debiting petitioner's account with $234.38 more than the market price of the $750,000 of certificates on December 23, 1957, and in crediting it with a little less than the market prices on January 3, and 20, 1958, when 2 lots of $250,000 and $500,000 were transferred, namely, $78.12 and $78.13, respectively. These differentials in Gibraltar's favor totaled $390.63.

Finally, consideration is given to whether petitioner's transaction with Gibraltar did or did not "appreciably affect his beneficial interest except to reduce his tax," and

what the possibilities were in that regard. *Knetsch* v. *United States*, *supra*, p. 366; *Bridges* v. *Commissioner*, 325 F. 2d 180, 184, *supra*.

It is apparent that petitioner could not have expected to realize profit out of the transaction with Gibraltar, and that no profit from a differential in interest rates or appreciated value could have been realized. Petitioner did not introduce any evidence to show that the transaction with Gibraltar was one entered into for profit. Any possible profit realized would have been *de minimis* without regard for the tax saving aspects.

In all of the facts and circumstances, there is the strong indication that the transaction with Gibraltar was destined from the beginning to produce no economic gain except a substantial reduction in petitioner's taxes, and that he was insulated from any appreciable gain or loss except for that built into the arrangement. Nothing in the record here is persuasive to the contrary. *Bridges* v. *Commissioner*, 325 F. 2d 180, 184, *supra*; *Knetsch* v. *United States*, *supra*, p. 366.

Upon the entire record, the only conclusion we can reach is that there was nothing of substance to be realized by petitioner from the transaction in question without regard for and except for the tax deduction,—the favorable tax consequences. It is obvious that petitioner did not have and could not reasonably have had any purpose or intention, in entering into the transaction, to appreciably affect his beneficial interest except to reduce his taxes, and nothing in the record establishes anything to the contrary.

Petitioner's primary reliance for his claimed interest deduction is upon *L. Lee Stanton*, *supra*. This case is distinguishable from *Stanton* because there (p. 7) the Com-

missioner conceded that the transactions were bona fide and real and created genuine indebtedness, and this Court found that the taxpayer undertook the risk of the rise and fall of the market. See *Joseph H. Bridges, supra,* p. 1079; and *Bridges* v. *Commissioner, supra,* p. 185. Such cases as the following, on which petitioner also relies, are also distinguishable from this case not only because they involved different statutes but also because in each of those the courts found the transactions to be in substance what they appeared to be in form and to have commercial reality: *Maysteel Products, Inc.* v. *Commissioner,* 287 F. 2d 429, reversing 33 T.C. 102; *Fabreeka Products Co.* v. *Commissioner,* 294 F. 2d 876, reversing 34 T.C. 290, and *Jack L. Sherman,* 34 T.C. 303, and *Sadie S. Friedman,* 34 T.C. 456.

The payment of $30,850.49 does not qualify as interest paid on indebtedness within the intendment of section 163(a) and deduction thereof must be disallowed.

Reviewed by the Court.

Decision will be entered under Rule 50.

FAY, *J.*, dissenting: The majority found that petitioner had failed to prove that his various transactions with Gibraltar were genuine and bona fide. However, I believe that the record clearly indicates (1) petitioner borrowed $750,000 from Gibraltar which he used to purchase United States Treasury certificates of indebtedness; (2) petitioner owned and used said Treasury certificates as collateral security for the repayment of his borrowings; and (3) petitioner actually paid interest with respect to the aforesaid borrowings. See my dissent in *Kapel Goldstein,* —— T.C.—— (1965).

In finding that petitioner failed to meet his burden of proof that a genuine indebtedness was created, the majority, in effect, wields said burden as a cudgel to strike down artful schemes producing tax benefits. The burden of proof provides no such tool. I envision such usage as subverting rule 31(b)(1), Tax Court Rules of Practice,[1] and placing an untoward burden on this Court and the judicial function we serve. In attempting to meet such a swollen concept of the burden of proof, a taxpayer will feel constrained to introduce the testimony of all witnesses whose testimony may relate to his case, regardless of how tangential or remote such testimony may be.

The majority opinion stresses the absence of a reasonable profit motive on petitioner's part. Moreover, it asserts: "Petitioner did not introduce any evidence to show that the transaction with Gibraltar was one entered into for profit." It must be borne in mind, however, that, unlike other deduction provisions, section 163 does not require that the expenditure be incurred in connection with a transaction entered into for profit. Therefore, I believe that the majority places an unjustifiable limitation upon the treatment of interest which cannot be reconciled with section 163,[2] absent congressional guidance in this direction. See *Commissioner* v. *Clay B. Brown*, ——U. S.—— (1965).

The majority goes on to state: "Any possible profit realized would have been *de minimis* without regard for

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1. Rule 31. EVIDENCE AND THE SUBMISSION OF EVIDENCE.
   (b) Stipulations. —
   Stipulations required.—The Court expects the parties to stipulate evidence to the fullest extent to which complete or qualified agreement can be reached including all material facts that are not or fairly should not be in dispute.

2. See *L. Lee Stanton*, 34 T.C. 1 (1960).

the tax saving aspects." With regard to this statement, I refer to Mr. Justice Harlan's concurring opinion in *Commissioner* v. *Clay B. Brown, supra,* wherein he stated:

> Were it not for the tax law, the [taxpayer's] transaction * * * would make no sense * * *. However the tax laws exist as an economic reality in the businessman's world, much like the existence of a competitor. Businessmen plan their affairs around both, and a tax dollar is just as real as one derived from any other source. * * *

HOYT, *J.*, dissenting: I must respectfully dissent from the majority opinion.

I cannot escape the conclusion that here the majority has adopted the general philosophy that we should not recognize a transaction which aside from any tax effects would produce an economic *loss* but which—because of the way the Internal Revenue Code is structured—produces a net economic gain solely as a result of decreased taxes. However, without plainly stating that it is adopting and applying this philosophy in deciding the instant case, the majority instead has made an effort to interpret the facts in such a way as to avoid a forthright statement of its position. By concluding that there was actually no bona fide indebtedness here, i.e., that the transaction was really a Livingstone-type "sham," I sense that we are adopting the rationale *sub silentio.* This has led to conflicting findings of fact and a conclusion (that there was no real indebtedness) which I feel is clearly erroneous.

There appears to be distinct conflicts in certain of the Court's findings. At one point there is a finding to the effect that Irving Trust, Gibraltar's New York bank, received the certificates here involved, purchased by

Gibraltar from First Boston Corporation. Pursuant to Gibraltar's instructions, Irving Trust, obviously acting as Gibraltar's bank and agent, delivered the certificates to Chemical, the New York correspondent bank of Cleveland Trust, from which Gibraltar borrowed the funds on its promissory note with which to purchase the certificates.

Later on in the findings the majority opinion states flatly, however, that "all of the certificates were with Chemical for the account of Cleveland Trust during all of the time involved in the whole transaction" and "Gibraltar never actually or physically had in its inventory or *possession* any of these certificates." (Emphasis supplied.) I am unable to reconcile these findings and it appears to me to be an inescapable conclusion that there were existing certificates purchased by Gibraltar for petitioner's account from First Boston and delivered to Gibraltar's New York bank per Gibraltar's instructions. It seems equally clear to me that there was a loan from Gibraltar to petitioner evidenced by petitioner's note; there was in turn a loan from Cleveland Trust to Gibraltar, funds were transferred pursuant thereto and used to pay the purchase price of the certificates.

While it is true that the certificates were used in a round-robin fashion to secure the various loans which were made, this was permitted under the terms of the loan to petitioner and I can only conclude that the loans here were real, not mere bookkeeping entries or paper transactions of the Livingstone type, and in no sense shams. The Court's findings make it evident that the transaction was real enough to result in receipts by petitioner of thousands of dollars in gains and interest, yet the majority would have it that petitioner never owned the certificates

or never owed Gibraltar on his note, and therefore cannot deduct the interest he paid thereon, even as I read the opinion, for the one month for which the loan was outstanding and in existence.

True, petitioner never personally received the certificates, which merely passed around among the various banks involved. But the banks and Gibraltar were acting on behalf of their respective principals throughout and once the conclusion is reached that there were existing certificates purchased, enforceable loans creating legal liabilities and an actual transfer of funds, then it seems to me that we cannot label all that occurred "a sham" and we should allow the deduction for "interest" paid during the taxable year.

The facts disclosed by the record in this case distinguish it completely from *Gordon MacRae*, 34 T.C. 20 (1960), affd. 294 F. 2d 56 (C.A. 9, 1961), certiorari denied 368 U. S. 955 (1962), and the line of so-called Livingstone cases on which the majority relies. Also, I cannot silently swallow the majority's casual brush-off of *L. Lee Stanton*, 34 T.C. 1 (1960). The distinction between the facts of *Stanton* and the facts here is not as apparent to me as it appears to be to my brothers. I also believe that *Knetsch* v. *United States*, 364 U. S. 361 (1960); *W. Stuart Emmons*, 31 T.C. 26, and *Weller* v. *Commissioner*, 270 F. 2d 294 (C.A. 3, 1959), affirming 31 T.C. 33, are factually distinguishable. I would much prefer to see us follow the rationale of *Stanton* in deciding this case on the facts disclosed. As we pointed out there, the disputed payments involved in the *Knetsch*, *Weller*, and *Emmons* cases were made to the life insurance companies which sold the annunities, and the "interest on the bank loans was not in controversy." *L.*

Lee Stanton, supra, at p. 10. We distinguished those cases by pointing out that the payments in issue were not interest but were in fact the purchase price of a tax deduction. Certainly we can and should continue to be vigilant to strike down sham transactions of this sort or of the Livingstone paper-bag-full-of-hot-air variety and disallow interest deductions claimed as a result thereof. However, in my view this is not such a case.

The payments petitioner seeks to deduct here were of interest, as I see it, paid for the use or forbearance of money. I do not subscribe to the view that to permit an interest deduction there must be a "valid commercial reason for paying interest," *Joseph H. Bridges,* 39 T.C. 1064 (1963), affd. 325 F. 2d 180 (C.A. 4, 1963); nor do I agree with the views of the majority here that such expense, to be deductible, must be incurred in a transaction entered into for profit, or in a transaction destined to produce an economic gain other than a substantial reduction in taxes. I would hold for the petitioner under the facts presented and leave corrective action to protect the revenue, if such is deemed desirable, to Congress. Meanwhile, I think we should permit a cash-basis taxpayer to deduct interest paid in a taxable year where he incurs a bona fide enforceable indebtedness, whatever his motive or purpose may have been. Even if a taxpayer is only seeking to save tax dollars by reducing his tax liability, and has no other economic purpose or profit motive in mind, he should be allowed all deductions which the law permits. *Gregory* v. *Helvering,* 293 U. S. 465 (1935); *L. Lee Stanton, supra.* See also my brother Fay's dissenting opinion filed herein, quoting from Mr. Justice Harlan's concurring opinion in *Commissioner* v. *Clay B. Brown,* —— U. S. —— (1965). Fay, *J.* agrees with this dissent.

Opinion of the United States Court of Appeals

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 272—September Term, 1965.

(Argued February 23, 1966 Decided July 22, 1966.)

Docket No. 30149

MAX BARNETT and ESTHER BARNETT,

Appellants,

—v.—

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Before:

WATERMAN, MOORE and FRIENDLY,

Circuit Judges.

Petition for review of adverse decision of the Tax Court of the United States, 44 T. C. 261, Harron, *J.*, in which that court had upheld a disallowance by the Commissioner of Internal Revenue of a deduction claimed by taxpayer to have been interest paid on indebtedness. Affirmed.

BERNARD SPEISMAN (Arnold Broser, of counsel), New York City, *for Appellants.*

JONATHAN S. COHEN, Attorney, Department of Justice; Richard M. Roberts, Acting Asst. Atty. Gen.; Lee A. Jackson, David O. Walter, Attorneys, Department of Justice, *for Respondent.*

Opinion of the United States Court of Appeals

PER CURIAM:

Max Barnett, the petitioner herein, and his wife who is a party only because the spouses filed a joint income tax return for the calendar year 1957, petition to review a decision of the Tax Court upholding the action of the Commissioner of Internal Revenue in disallowing a deduction for federal income tax purposes of a payment of $30,850.49 made by petitioner to Gibraltar Financial Corporation on December 26, 1957, which petitioner, a taxpayer reporting on the cash accounting method, claims was a payment of interest on indebtedness within Section 163(a) of the 1954 Internal Revenue Code. In a careful opinion detailing all the pertinent facts, many of which had been stipulated, the Tax Court held that this payment was not deductible because the loan transaction had no substance apart from its anticipated tax consequences and was a "sham" that created no real indebtedness. *Barnett* v. *Commissioner*, 44 T. C. 261 (1965). We affirm.

In 1957 petitioner received $50,000 as a prize for winning a newspaper contest, and this case arises out of a plan for reducing petitioner's 1957 income taxes by taking a deduction for the alleged payment in December of that year of $30,850.49 as claimed prepaid interest on a loan to finance the purchase of $750,000 of U. S. Treasury obligations. This plan is similar to, but significantly more transparent than, the plan devised by the taxpayer and her advisors in *Goldstein* v. *Commissioner*, —— F. 2d —— (2 Cir. 1966), also decided today. In this case, as in *Goldstein*, the Tax Court concluded on the basis of sufficient evidence that the petitioner could not have expected to realize a profit on the transaction and that the transaction had no purpose, utility, or substance apart from the tax consequences petitioner anticipated it would have. It fol-

lows from what we said in *Goldstein* that the Tax Court's disallowance of the deduction must be affirmed. See —— F. 2d at ——.[1]

Moreover, in the present case, unlike the situation in *Goldstein*, the nature of the diaphanous arrangement between petitioner and Gibraltar (as differentiated from the arrangement between Gibraltar and the various financial institutions Gibraltar involved in its financial "round robin"), plus the extremely short duration of the loan transaction,[2] lead us without peradventure of doubt to conclude that the Tax Court was correct in determining that the purported loan transaction here was indeed without substance and was a "sham" of the discredited *Goodstein* variety. *Goodstein* v. *Commissioner*, 267 F. 2d 127 (1 Cir. 1959), *affirming* 30 T. C. 1178 (1958). And see 4 Mertens, *Law of Federal Income Taxation*, §26.04a (1960 Revision and Supplements).

We affirm on this ground as well as on the other grounds the Tax Court so ably and exhaustively advanced.

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1 We point out, as we did in *Goldstein*, that our discussion of a taxpayer's tax avoidance motives is only pertinent to Section 163(a). We do not hold that the existence of a tax avoidance motive, standing alone, is always, or even usually, sufficient to disallow a taxpayer the tax consequences he hopes for when he enters into a transaction. We here hold that Congress did not "intend" Section 163(a) to be utilized by taxpayers who are motivated to borrow funds for no other reason than to obtain a Section 163(a) deduction. Section 163(a) does not "intend" that a deduction be allowed in such a case. See *Knetsch* v. *United States*, 364 U. S. 361, 365 (1960); *Goldstein* v. *Commissioner*, —— F. 2d —— (2 Cir. 1966).

2 On December 26, 1957, petitioner paid Gibraltar $30,850.49 as "prepaid interest" for nine months at the rate of 5½% on the principal sum of $747,890.63 which, with other monies, was to be used to acquire $750,000 of 3¼% Treasury certificates at a very slight premium over face. Gibraltar made purchases and sales so that by January 20, 1958 taxpayer's "sham obligation" to it was fully paid. Gibraltar paid petitioner $9,140.89 on January 3, 1958 and $18,282.17 on January 20, 1958, representing a refund of $27,423.06 in calendar 1958 of the "prepaid interest" of $30,850.49 paid in calendar 1957.

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Supreme Court of the United States

OCTOBER TERM, 1966

No. 728

MICHAEL J. IPPOLITO and AGNES IPPOLITO,
Petitioners,

—against—

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

APPENDIX TO PETITION FOR A WRIT OF CERTIORARI

BERNARD SPEISMAN
Attorney for Petitioners
711 Fifth Avenue
New York, N. Y.

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Of Counsel

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Findings and Opinion of Tax Court

T. C. Memo. 1965-167

TAX COURT OF THE UNITED STATES

MICHAEL J. IPPOLITO AND AGNES IPPOLITO, Petitioners, *v.* COMMISSIONER OF INTERNAL REVENUE, Respondent.

Docket No. 84486. Filed June 24, 1965.

George V. Delson and *Arnold Broser*, for the petitioners.

Robert D. Whoriskey and *Lee A. Kamp*, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION.

FAY, *Judge:* Respondent determined a deficiency in the petitioners' income tax for the calendar year 1955 in the amount of $44,608.79. The parties have disposed of certain issues raised in the pleadings. The remaining issues for decision are:

(1) Whether petitioners are entitled to deduct, within the meaning of section 163(a) of the Internal Revenue Code of 1954,[1] the amount of $37,777.77 in 1955 as prepaid interest on a purported indebtedness;

(2) Whether petitioners are entitled to deduct under any provision of the Internal Revenue Code of 1954 a loan placement fee in the amount of $2,500 to the Gibraltar Financial Corporation in connection with a loan of $1,000,000;

(3) Whether petitioners are entitled to deduct a claimed $6,000 fee under the provisions of section 212, paid to a

1. Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954.

certified public accountant retained for financial management and tax assistance, disallowed by respondent to the extent of $5,000; and

(4) Whether, as an alternative, petitioners can deduct in 1955 net out-of-pocket expenses in the amount of $4,458.18, incurred by petitioners in connection with a loan of $1,000,000 to purchase United States Treasury Certificates of Indebtedness with borrowed funds.

FINDINGS OF FACTS.

Some of the facts have been stipulated and, as stipulated, are incorporated herein by this reference.

Petitioners Michael J. Ippolito and Agnes Ippolito are husband and wife residing in Huntington Station, Suffolk, New York. They filed a joint Federal income tax return, on the cash receipts and disbursements basis, for the calendar year 1955 with the district director of internal revenue, Brooklyn, New York.

References to petitioner hereinafter are intended to apply to Michael J. Ippolito.

During the year 1954, petitioner was found to be the holder of a winning ticket on the Irish Sweepstakes and, in 1955, collected $138,567.50.

On or about December 23, 1955, petitioner, through his accountant, purchased from the Gibraltar Financial Corporation (hereinafter referred to as GFC) $1,000,000 face amount of UU. S. Treasury Certificates of Indebtedness (hereinafter called Treasury certificates), 2⅝ percent due December 1, 1956, at a price of 100.1.

December 23, 1955, fell on a Friday and the next business day was Tuesday, December 27, 1955. Normally, in

the Government bond market, the settlement date (i.e., the day on which delivery of securities and payment therefor occur) falls on the next business day following the transaction date.

Petitioner executed a note, with recourse, dated December 27, 1955, for $1,000,000 payable to GFC for the balance of the purchase price, bearing interest at the rate of 4 percent per annum and due December 1, 1956. The promissory note provided, *inter alia,* as follows:

(a) As security for the payment of the note, the petitioner pledged with GFC the $1,000,000 face value of Treasury certificates.

(b) Petitioner could prepay the principal sum of the loan at any time without penalty except that if prepayment occurred within 30 days from the date of the note, he would be liable for 30 days' interest thereon.

(c) Petitioner gave GFC, among other things, the right to hypothecate and rehypothecate said securities.

Petitioner paid GFC $1,864.75 by check as margin on the purchase of the Treasury certificates.

On or before December 27, 1955, petitioner paid, by check, $37,777.77 to GFC representing interest on the note for $1,000,000 to the maturity of the note.

On or before December 27, 1955, petitioner paid $2,500, by check, to GFC as a loan placement fee in connection with the $1,000,000 loan.

GFC was a dealer in municipal, State and local bonds. On or about December 23, 1955, GFC purchased $1,000,000 face amount of Treasury certificates (evidenced by certificate No. 1068) from C. J. Devine & Co. (hereinafter referred to as Devine), a well-known dealer in Govern-

ment bonds. On that date, GFC instructed Devine to deliver the said Treasury certificates to Irving Trust Company (hereinafter referred to as ITC) and to receive payment from ITC in the amount of $1,001,552.25.

On December 27, 1955, Devine delivered the Treasury certificates, through its agent, Manufacturers Trust Company, to ITC. Upon receipt of the Treasury certificates (December 27, 1955), ITC paid Devine $1,001,552.25 through its agent. On that date ITC mailed its debit advice to GFC acknowledging receipt of the Treasury certificates for GFC's account.

By a letter dated December 30, 1955, from GFC to petitioner in care of petitioner's accountant, GFC acknowledged receipt of the securities which were held as collateral under the terms of the note.

On or about December 27, 1955, GFC borrowed from Cleveland Trust Company (hereinafter referred to as CTC) a total of $1,945,000 on a 3½ percent interest demand note pledging as collateral security therefor $2,000,000 face amount of Treasury certificates. As part of such borrowing by GFC from CTC, GFC rehypothecated the $1,000,000 face amount of the Treasury certificates previously pledged with it by petitioner to secure $965,000 of the aforesaid total loan of $1,945,000.

On December 27, 1955, ITC sent GFC a credit advice memo reflecting the wire transfer of the Treasury certificates through the Federal Reserve Bank, Cleveland, Ohio, for the account of CTC.

Pursuant to the delivery by ITC to the Federal Reserve Bank of New York, ITC received from CTC $1,945,000 which it credited to the account of GFC. The receipt of such funds by GFC was recorded on its books as "Loans Payable—CTC."

Findings and Opinion of Tax Court

On or about January 12, 1956, petitioner sold to GFC the $1,000,000 face amount of Treasury certificates at a price of 100$^{4}/_{64}$ for a total price of $1,000,468.75 plus accrued interest of $3,084.02. Such transaction was recorded on the books and records of GFC as a purchase by it of the Treasury certificates from petitioner and the account for petitioner was credited with the total price.

On or about January 12, 1956, GFC advised ITC by letter to receive from CTC $1,000,000 face amount of Treasury certificates by Federal Reserve wire transfer against payment of $965,000.

On or about January 13, 1956, ITC advised GFC that on January 13, 1956, ITC had received $1,000,000 Treasury certificates from CTC through the Federal Reserve Bank for the account of GFC against payment of $965,000.

On or about January 12, 1956, GFC sold the $1,000,000 face amount of Treasury certificates to Devine at 100$^{32}/_{64}$ plus $^{1}/_{64}$ for a total price of $1,000,781.25, plus accrued interest of $3,084.02. Such transaction was recorded on the books of Devine as a purchase.

On or about January 13, 1956, ITC advised GFC that on January 13, 1956, ITC had delivered the said Treasury certificates to Devine and that payment had been received in the amount of $1,003,865.27. Such amount was credited to GFC's regular checking account. As a result of the aforesaid transaction, GFC repaid the $965,000 loan which it had received from CTC, and the $1,000,000 Treasury certificates which were held by CTC as collateral security were released to GFC.

On or about January 17, 1956, GFC mailed an advice to petitioner stating that there was a balance in petitioner's account in the amount of $3,240.27.

On or about January 17, 1956, GFC mailed its check in the amount of $3,240.27 to petitioner representing the balance in the account.

On or about January 17, 1956, GFC mailed an advice to petitioner reflecting a crediting of his account in the amount of $34,444.47 for a rebate of interest previously prepaid in accordance with the terms of the note. On the same day GFC mailed its check in the amount of $34,444.47 to petitioner. Such amount was recorded on GFC's books as a reduction in interest income recorded by it and credited to the special loan account.

Petitioners reported in their 1956 joint income tax return a short-term capital gain in the amount of $156.25 arising out of the purchase and sale of the Treasury certificates. Petitioners also reported in their 1956 income tax return interest income in the amount of $35,763.34 consisting of (1) interest earned on the Treasury certificates from December 27, 1955, to January 13, 1956, in the amount of $1,319.27[2] and (2) interest refunded from GFC in the amount of $34,444.07.

The transactions engaged in by petitioner, referred to herein, resulted in an out-of-pocket loss to petitioner (without regard to the tax consequences in issue) in the amount of $4,458.18. Petitioner's "out-of-pocket loss" incurred in connection with the $1,000,000 loan transaction is computed as follows:

Interest paid	$37,777.77	
Loan placement fee	2,500.00	
Total		$40,277.77
Capital gains reported	$ 156.25	
Interest on Treasury certificates	1,219.27	
Interest refund	34,444.07	
		$35,819.59
Net out-of-pocket loss		$ 4,458.18

2. The correct amount of interest on the Treasury certificates was $1,219.27.

Petitioner paid fees of $6,000 in 1955 to a certified public accountant (hereinafter referred to as the CPA), whom he retained for tax and financial advice. Such services were rendered to petitioner during the years 1954, 1955, and 1956. Upon being engaged by petitioner, the CPA initially addressed (1) the problem of safeguarding petitioner's claim to the sweepstakes winnings (hereinafter referred to as the winnings) and (2) the actual collection thereof. Prior to receipt of the winnings, the CPA made efforts to determine the potential tax consequences to petitioner resulting from such receipt. He also attempted to ascertain by what means such tax consequences could be alleviated. The CPA filed out petitioner's tax returns for the year 1955.

In his capacity as petitioner's investment counselor, the CPA investigated various investment possibilities, including oil royalties and real estate. He arranged to pay off petitioner's car loan and purchased mutual funds for petitioner. The CPA also advised petitioner on the $1,000,000 loan-Treasury certificate acquisition and arranged with GFC for petitioner to enter into such transaction. However, GFC rather than the CPA was the party responsible for arranging that transaction.

Petitioners claimed as a deduction in their Federal joint income tax return for the year 1955 (1) an interest expense in the amount of $37,777.77 paid to GFC, (2) a loan placement fee in the amount of $2,500 paid to GFC, and (3) a $6,000 fee paid to a CPA for financial management and tax assistance. Respondent disallowed (1) the $37,777.77 paid to GFC on the grounds that it did not represent payments of interest on indebtedness within the meaning of section 163 (a) the $2,500 loan placement

fee on the ground it did not represent an allowable deduction under any of the provisions of the Internal Revenue Code of 1954, and (3) the $6,000 fee paid to a CPA to the extent of $5,000 for the reason that it did not represent an ordinary and necessary expense within the meaning of sections 161 and 212.

OPINION.

The principal question to be decided in the instant case is whether the Commissioner erred in disallowing deductions for interest paid in 1955 on indebtedness. Section 163(a) of the Internal Revenue Code of 1954, applicable to the year involved herein, provides that in computing net income there shall be allowed as a deduction "all interest paid * * * within the taxable year on indebtedness."

Respondent takes the position that petitioner is not entitled to a deduction of $37,777.77 in 1955 under section 163 or any other section of the Internal Revenue Code because the indebtedness upon which interest was paid was part of a sham transaction, devoid of commercial reality and its only end the obtaining of a tax deduction. Petitioner contends that the transaction in question was not lacking in substance or commercial reality and resulted in the creation of a valid, bona fide loan upon which interest was due and paid by petitioner and thereby deductible under section 163.

We believe that this Court's recent decision in *Kapel Goldstein*, 44 T.C. —— (May 28, 1965),[3] is determinative of this issue and we therefore hold for respondent.

In order to obtain the $1,000,000 loan, petitioner was required to pay GFC a $2,500 loan placement fee, in addi-

3. See also *Max Barnett*, 44 T.C. —— (May 28, 1965).

tion to interest at the rate of 4 percent per annum. GFC wanted this additional sum in order to make what it considered sufficient profit. Consequently, we believe that this issue also is controlled by *Kapel Goldstein, supra,* and, thus, we hold for respondent.

During the years 1954, 1955, and 1956, petitioner retained the services of a CPA for tax and financial advice. In consideration of these services, petitioner paid said accountant $6,000 in 1955, which sum petitioner deducted in his income tax return for the same year. Respondent disallowed $5,000 of that deduction on the ground that such amount relates to the "Government bond" transaction. Regardless of any allocation which respondent may contend for, it is obvious from the record that the accountant's services consisted solely of financial and tax advice. Respondent does not contend otherwise. Amounts expended for such purposes are properly deductible under section 212. Thus, we hold that the entire $6,000 fee paid to the CPA is deductible by petitioner.

The final issue to be considered is whether petitioner, as an alternative to deducting $37,777.77 prepaid interest and $2,500 loan placement fee, can deduct in 1955 a net out-of-pocket loss in connection with the $1,000,000 loan transaction.[4]

Although petitioner's expenses were incurred and paid in 1955, the following amounts received in 1956 are clearly necessary to petitioner's net out-of-pocket loss computa-

4. To be deductible, such item must qualify as a loss under section 165, I.R.C. 1954.

SEC. 165. LOSSES.

(a) General Rule.—There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

tion, to wit: $156.25 capital gains; $1,219.27 interest on Treasury certificates; and $34,444.07 interest refund. Therefore, petitioner's net out-of-pocket loss could not possibly have been sustained in 1955 (the year involved herein) since the transaction generating such loss was not completed until the above amounts were received in 1956. *Goodstein* v. *Commissioner*, 267 F.2d 127, 132 (C.A. 1, 1959), affirming 30 T.C. 1178 (1958). Thus, we hold for respondent on this issue.

Decision will be entered under Rule 50.

Opinion of the United States Court of Appeals

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 273—September Term, 1965.

(Argued February 23, 1966 Decided July 22, 1966.)

Docket No. 30150.

MICHAEL J. IPPOLITO and AGNES IPPOLITO,

Appellants,

—v.—

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Before:

WATERMAN, MOORE and FRIENDLY,

Circuit Judges.

Petitioner seeks reversal of Tax Court determination, T. C. Memo 1965-167, Fay, *J.*, upholding a disallowance by the Commissioner of a purported payment of prepaid interest taxpayer paid and for which he took a deduction on his 1955 calendar year income tax return. The Tax Court is affirmed.

BERNARD SPEISMAN (Arnold Broser, of counsel), New York City, *for Appellants.*

JONATHAN S. COHEN, Atty., Dept. of Justice; Richard M. Roberts, Acting Asst. Atty. Gen.; Lee A. Jackson, David O. Walter, Attys., Dept. of Justice, *for Respondent.*

WATERMAN, *Circuit Judge*:

Michael J. Ippolito, a cash method of accounting taxpayer, herein referred to as the petitioner, together with his wife who is a party only because the Ippolitos filed a joint return for the calendar year 1955, petition to review a decision of the Tax Court upholding the disallowance by the Commissioner of a claimed deduction for federal income tax purposes of a payment of $37,777.77 made by petitioner to Gibraltar Financial Corporation in December 1955, which payment petitioner claims was deductible as a payment of prepaid interest on indebtedness within Section 163(a) of the 1954 Internal Revenue Code. The Tax Court, relying on its May 28, 1965 opinion in *Goldstein* v. *Commissioner,* 44 T. C. 284 (5 Tax Court judges dissenting), *aff'd* this day, —— F. 2d —— (2 Cir. 1966), and citing its May 28, 1965 opinion in *Barnett* v. *Commissioner,* 44 T. C. 261 (2 Tax Court judges dissenting), *aff'd* this day, —— F. 2d —— (2 Cir. 1966), disallowed the deduction in a memorandum opinion of June 24, 1965, reported as T. C. Memo, 1965-167. We affirm the Tax Court.

The entire transaction between petitioner and Gibraltar was initiated and concluded within 25 days, from December 23, 1955 to January 17, 1956, and plainly showed at its inception that the transaction, except for its tax consequences, would inevitably result in a financial loss to petitioner.

Opinion of the United States Court of Appeals

During the year 1954 petitioner was the holder of an Irish Sweepstakes winning ticket, and, in 1955, collected $138,567.50.

On or about December 23, 1955 petitioner purchased from Gibraltar $1,000,000 face amount of U. S. Treasury Certificates 2⅝%, due December 1, 1956, at a price of 100.1. Petitioner paid Gibraltar a loan placement fee of $2,500 and paid Gibraltar $1,864.75 as margin on the purchase of the Treasury Certificates. Petitioner executed a note, with recourse, dated December 27, 1955, for $1,000,000 payable to Gibraltar, for the balance of the purchase price, bearing interest at the rate of 4% per annum and due December 1, 1956. On or before December 27, 1955, petitioner paid $37,777.77 to Gibraltar representing interest on the note for $1,000,000 to December 1, 1956, the maturity date of the note, and the date when the Treasury Certificates were due to be paid at face.

The promissory note provided, *inter alia*: (a) As security for the payment of the note, the petitioner pledged with Gibraltar the $1,000,000 face value of the Treasury Certificates; (b) Petitioner could prepay the principal sum of the loan at any time without penalty except that if prepayment occurred within 30 days from the date of the note, he would be liable for 30 days' interest thereon; (c) Petitioner gave Gibraltar, among other things, the right to hypothecate and rehypothecate the Treasury Certificates.

On or about December 23, 1955 Gibraltar initiated a series of transactions between financial institutions, which began with its purchase of $1,000,000 face amount of Treasury Certificates from C. J. Devine & Co. on that day and ended with the purchase by C. J. Devine & Co. from Gibraltar of the Certificates on January 12, 1956. This series of transactions is detailed in the Tax Court's memorandum opinion and need not be again set forth in detail here.

In this way, the purported collateral, which of course petitioner never saw, having been sold, petitioner's note to Gibraltar was duly liquidated without any affirmative action being required of petitioner, and on or about January 17, 1956, Gibraltar informed petitioner that his account had been credited in the amount of $34,444.47 representing a rebate of interest previously prepaid in accordance with the terms of the note. On the same day Gibraltar mailed its $34,444.47 check to him.

Though the facts are carefully set forth by the Tax Court, the opinion in the present case is somewhat sketchy, presumably because the court in *Goldstein, supra,* and in *Barnett, supra,* decided by the court less than a month earlier, had in the opinions in those cases exhaustively discussed the same rationales of decision. The arrangement petitioner had with Gibraltar Financial Corporation differs in no significant respect from the arrangement Gibraltar had with *Barnett.* Although here the Tax Court did not explicitly find as an "ultimate fact," as it had found in *Barnett,* that the transaction between petitioner and Gibraltar had no purpose, utility, or substance apart from the tax consequences anticipated by petitioner, the facts the Tax Court did find fully warrant the same conclusion.

We affirm in this case on the ground that the nature of the arrangement between petitioner and Gibraltar (as differentiated from the arrangement between Gibraltar and the various banks involved) and the extremely short duration of the transaction, justified the Tax Court's conclusion that the transaction entered into by petitioner, being devoid of commercial reality and having as its only conceivable purpose that of obtaining a large Section 163(a) deduction in 1955, was a "sham."

Affirmed.

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241-214—66——1

In the Supreme Court of the United States

OCTOBER TERM, 1966

No. 728

KAPEL GOLDSTEIN AND TILLIE GOLDSTEIN, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

MAX BARNETT AND ESTHER BARNETT, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

MICHAEL J. IPPOLITO AND AGNES IPPOLITO, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The findings of fact and opinions of the Tax Court in *Goldstein* (App. 25a–64a), *Barnett* (App. 1a–40a), and *Ippolito* (App. 1a–10a) are respectively reported at 44 T.C. 284, 44 T.C. 261, and T.C. Memo, No.

1965–167. The respective opinions of the court of appeals (*Goldstein* App. 65a–80a; *Barnett* App. 41a–43a; *Ippolito* App. 11a–14a) are reported at 364 F. 2d 734, 364 F. 2d 742 (*per curiam*), and 364 F. 2d 744.

JURISDICTION

The judgments of the court of appeals were entered on July 22, 1966. On October 20, 1966, Mr. Justice Harlan extended the time for the filing of the petition for a writ of certiorari to and including November 3, 1966. The petition for a writ of certiorari was filed on October 27, 1966. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Near the end of the tax years in which petitioners won very large taxable prizes (between $50,000 and $140,000), they purported to purchase substantial amounts of Treasury obligations, borrowing the full purchase price and pledging the Treasury obligations on the loans. Petitioners prepaid large amounts of interest in advance and took immediate tax deductions for these amounts, which offset a substantial portion of their fortuitous income. See 1954 Code § 163. Since petitioners were paying a higher rate of interest on the loans than they were earning on the Treasury obligations, there was no reasonable chance that they would profit from the transactions aside from the tax deductions. Subsequently the Treasury obligations were sold and the loans were satisfied out of the proceeds. The question presented is whether the court of appeals correctly denied petitioners' claimed deductions for the prepaid interest.

STATEMENT

The three cases consolidated in the petition for a writ of certiorari have a common pattern. Petitioners[1] fortuitously acquired considerable sums of money in a single year which increased their family income well above its usual annual level. Two of the petitioners won more than $135,000 in the Irish Sweepstakes, and the third won a $50,000 prize in a newspaper contest. Each petitioner, just before the close of the particular taxable year in which he or she had won the prize, purported to borrow hundreds of thousands of dollars to invest in government bonds (which were pledged as collateral for the loans), and to make large cash outlays as prepayments of interest. Each petitioner then claimed these large prepayments of interest as deductions to offset their unusually high earnings that year. The Commissioner disallowed those claimed deductions. (*Barnett* App. 42a–43a; *Ippolito* App. 12a–13a; *Goldstein* App. 66a–68a.)

The following is a brief outline of the transactions and the decisions of the courts below.

1. *The Barnett case.* In 1957 Max Barnett won a $50,000 taxable prize in a newspaper contest. In December of that year he purported to purchase at approximately par from Gibraltar Financial Corporation (Gibraltar) $750,000 par value United States Treasury certificates, bearing interest at 3¾ percent, due on December 1, 1958. Barnett executed a promissory note payable to Gibraltar for the full purchase

[1] The three petitioners' spouses are parties to the suit solely because joint returns were filed.

price, due nine months thereafter, bearing interest at the rate of at least 5½ percent. Barnett gave Gibraltar a check for $30,850 in prepayment of the entire nine months' "interest."[2] The Treasury certificates were pledged as security for the "loan." (*Barnett* App. 8a–10a.)

Gibraltar, however, had neither $750,000 of Treasury certificates nor cash with which to purchase them. It therefore purchased the certificates at a price slightly less than it had charged Barnett, had them, delivered to a bank, Cleveland Trust, which paid for them, and Gibraltar gave the bank a promissory note for the purchase price bearing interest at 4%. (*Id.*, 5a–10a.)

In January 1958, without further consultation with Barnett, Gibraltar purported to repurchase the certificates from him, and to immediately resell them. Gibraltar credited Barnett's account with slightly less than the sales price. The transactions were thus completed within 30 days after they had begun and Barnett received a rebate of approximately 8/9 of the "interest" he had paid in December 1957. Taking into account a small amount supposedly representing short-term gain on the sale of the certificates and interest earned on them, Barnett sustained an out-of-pocket loss on the deal of $139. (*Id.*, 11a–15a, 20a.)

The Tax Court found that Barnett never acquired control over the certificates, and that the transactions with Gibraltar were sham (*Id.*, 23a–24a). Gibraltar,

[2] Barnett also gave Gibraltar approximately $9,000 margin which was later returned (*Barnett* App., pp. 8a, 19a).

for a fee, merely provided "the color and form for petitioner's claim for a deduction for alleged interest" (*id.*, 33a). The Tax Court further determined "that no profit [to Barnett] from a differential in interest rates or appreciated value could have been realized," and noted that Barnett had not shown any possibility of economic gain. "[T]here was nothing of substance to be realized by petitioner from the transaction in question without regard for and except for the tax deduction." (*Id.*, 34a) The Tax Court therefore upheld the Commissioner's disallowance of the interest deduction claimed for 1957, and the court of appeals affirmed (*id.*, 41a–43a).

2. *The Ippolito case.* In 1955 petitioner Ippolito collected over $138,000 as a winner of the Irish Sweepstakes. In December of that year he entered into the same types of transactions with Gibraltar as did Barnett (Compare Pet. 25–27 with Pet. 22–24). As with Barnett, the transactions came to an end within 30 days. Ippolito suffered an out-of-pocket loss of approximately $4,400, and claimed a deduction for prepaid interest of some $37,000. The Tax Court again upheld the Commissioner's disallowance of the deduction, and the court of appeals affirmed on the same grounds as in the *Barnett* case. (*Ippolito* App. 12a–14a.)

3. *The Goldstein case.* Petitioner Goldstein and her husband, who was retired, had an average annual income of less than $1,000. In 1958 she won over $140,000 in the Irish Sweepstakes. In December 1958 she purported to borrow $945,000 from two banks and

to purchase, at a discount, $1,000,000 par value Treasury notes bearing interest at 1½ percent, due to mature on October 1, 1961. The Treasury notes were pledged as collateral for the loans. She paid the banks $81,000 as a prepayment of more than 1½ years interest on the bank loans.[3] By June 1960, at the latest, the transactions had terminated with a net economic loss to petitioner of approximately $25,000. (*Goldstein* App. 33a–36a, 38a–39a, 67a–68a, 73a.)

The lower courts concluded that petitioner entered into the transactions "without any realistic expectation of economic profit and 'solely' in order to secure a large interest deduction in 1958 (*id.*, 76a). Calculations made by her son, who was an accountant, at the time the transactions were planned, indicated that there would be an economic loss on the transactions in excess of $18,500. Mrs. Goldstein was paying 4 percent interest on the bank loans while earning approximately 2 percent interest on the Treasury notes and a modest gain when they were sold. (As the maturity date approached, the notes' market value moved toward par, thus creating a slight gain to augment the low interest yield.) (*Id.*, 72a–73a).[4]

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[3] She also paid a fee of $6,500 to her tax and investment advisors (*Goldstein* App. 75a).

[4] At trial, petitioner sought to establish that it was possible to have made a small profit. The supporting exhibits were not credited by the Tax Court. The court of appeals noted, *inter alia*, that the exhibits showed a profit only as a result of the failure to include all outlays made by Mrs. Goldstein, and that the calculations were also premised on an unreasonably high capital appreciation. (*Id.*, 74a–76a.)

Mrs. Goldstein could have secured an economic gain on the

The Tax Court held that the transactions were lacking in substance, and were shams as payments of interest. The court of appeals rejected the "sham" label because petitioner's transactions were regular in form and it believed that there was insufficient evidence to establish that the banks had intended to create only the facade of a loan (*id.*, 69a–71a), but affirmed the decision of the Tax Court on the ground that the Code did not permit a deduction for interest on loan arrangements "that can not with reason be said to have purpose, substance, or utility apart from their anticipated tax consequences" and which are thus motivated solely by tax avoidance (*id.*, 77a, 79a).

ARGUMENT

The decisions below are correct, and there is no conflict of decisions or other reason for further review.

1 (a). *The Goldstein case.* The court of appeals, although unwilling to refer to Mrs. Goldstein's transactions as shams, correctly held that her prepayment of interest did not qualify for a deduction under 1954 Code § 163. The interdependent loan transactions and Treasury note purchases did not meet the test for the allowance of an interest deduction stated in *Knetsch* v.

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transactions only if, at the time the loans came due, the Treasury notes were selling considerably in excess of par value (*id.*, 54a–55a). This was highly unlikely. The notes were scheduled to mature in 1961 and bore interest at the rate of only 1½ percent. Thus anyone who purchased them at more than par in 1959 or 1960 would receive less than 1½ percent effective return on his money and also suffer a loss at maturity.

United States, 364 U.S. 361. Petitioner's complex transactions "did 'not appreciably affect [her] beneficial interest except to reduce [her] tax' " and "it is patent that there was nothing of substance to be realized [by her] from this transaction beyond a tax deduction." 364 U.S. at 366. In December 1958 she paid in excess of $87,000 in interest and fees. No reasonable appreciation in the value of the Treasury 1½ percent notes together with the interest they would produce could return more than her 1958 outlays, even if the notes were held for the entire period of the bank loans. Petitioner's massive loans could be explained on no rational commercial basis, other than as a patent effort to obtain a large interest deduction in 1958, with its anticipated effect of reducing the tax liability on her sweepstakes winnings.

Petitioner argues, however, that the court below erroneously took into account her tax avoidance motivation, and that the decision was therefore a misapplication of *Knetsch* (Pet. 18–19). This is not so. Judge Waterman's opinion for the court explicitly stated that (*Goldstein* App. 77a):

> We hold * * * that Section 163(a) of the 1954 Internal Revenue Code does not permit a deduction for interest paid or accrued in loan arrangements, like those now before us, that can not with reason be said to have *purpose, substance,* or *utility* apart from their anticipated tax consequences. [Emphasis added.]

The court thus spoke of economic realities rather than motivation. To be sure, the opinion also discussed motive, but only if first "it *objectively appears*

that a taxpayer has borrowed funds in order to engage in a transaction that has no substance or purpose aside from the taxpayer's desire to obtain the tax benefit" (*Goldstein* App. 79a, emphasis added). The court below stated that the interest deduction must be allowed (1) if there is substance to the loan transaction, irrespective of motive, or (2) if borrowing has utility, although selected as a means of financing because of its tax effects, or (3) if an intention to obtain a tax deduction is mixed with other motives (*Goldstein* App. 78a).[5] This outline of the factors necessary to meet the requirements of § 163, while general in scope, trenches on no proper loan transactions. It is essentially a restatement of the core of the *Knetsch* ruling—that a transaction, to support an interest deduction, must have some measure of independent significance apart from beneficial tax effects. The principal difference is that the instant opinion would allow a deduction when a transaction does not comply with objective standards yet

[5] Judge Waterman's opinion stated (*ibid.*):

> * * * Section 163(a) shsould be construed to permit the deductibility of interest when a taxpayer has borrowed funds and incurred an obligation to pay interest in order to engage in what with reason can be termed purposive activity, even though he decided to borrow in order to gain an interest deduction rather than to finance the activity in some other way. In other words, the interest deduction should be permitted whenever it can be said that the taxpayer's desire to secure an interest deduction is only one of mixed motives that prompts the taxpayer to borrow funds; or, put a third way, the deduction is proper if there is some substance to the loan arrangement beyond the taxpayer's desire to secure the deduction. * * *

the taxpayer had actually believed that there was a real possibility of economic benefit (*i.e.*, the transaction was prompted by mixed motives and not motivated solely by tax avoidance). See *Stanton* v. *Commissioner*, 34 T.C. 1. The soundness of this supplement to the *Knetsch* principles is not raised by this case, since petitioner failed to prove that she had any non-tax-avoidance motivation. Thus, the decision below cannot seriously be said to be in conflict with *Knetsch*.

We believe, moreover, that the Second Circuit's application of the *Knetsch* approach was unquestionably appropriate in the context of this case. The bank loans and petitioner's purchases of Treasury notes were mutually dependent in that neither could have occurred but for the other; so long as petitioner held the Treasury notes, they would be pledged to secure the loans (except in the "wholly unlikely" event that petitioner could or would pay the principal amount of the debt[*] (see *Knetsch*, *supra*, at 366, fn. 3)). The two categories of transactions were thus inseparably linked, and it follows that they must be viewed together. Like *Knetsch*, which involved a single-premium annuity coupled with a loan, petitioner's Treasury notes tied to the bank loans had at least the potentiality for self-cancellation. That alone warranted an inquiry into the effect of the transactions, if any, on petitioner's beneficial interest. And it is plain that petitioner in fact stood to realize nothing

[*] Mrs. Goldstein did not have the funds to pay the debt, nor did she have sufficient assets or personal credit to raise $900,000 to $1,000,000. (See *Goldstein* App. 67a.)

of substance from the loan and Treasury note transactions beyond a tax deduction.

(b). There is no conflict of decisions. The Fourth Circuit, in a similar "interest deduction" scheme denied a claimed deduction. *Bridges* v. *Commissioner*, 325 F. 2d 180. Although the Fourth Circuit called the Transactions shams, it is clear that both the Second and Fourth Circuits applied the reasoning of the *Knetsch* decision to the type of dealings in issue before them. See also *Ballagh* v. *United States*, 331 F. 2d 874 (Ct. Cl.), certiorari denied, 379 U.S. 887, and the numerous cases cited, *infra*, pp. 12–13.

Petitioner argues that *Fabreeka Products Co.* v. *Commissioner*, 294 F. 2d 876 (C.A. 1), is in conflict "in controlling principle" with the decision below (Pet. 16). In *Fabreeka* the taxpayer (a corporation) purchased, at a premium, bonds which were callable on 30 days notice with the intention of holding the bonds for 30 days, deducting the premium paid under § 171 of the 1954 Code, and distributing the bonds as a dividend to its shareholders. The court concluded that the taxpayer had actually purchased the bonds and that during "the necessary holding period [it] incurred fully all the risks of ownership, both that the bonds might decline in value, a real risk, as [the taxpayer in a related case] learned to his cost, and the possibilities that during that time they might be called." 294 F. 2d at 878. Unlike the present case, the corporation's purchase and ownership of the bonds did not lack substance under objective standards, and motive was therefore immaterial. Moreover, § 171 of the 1954 Code, with which the court was concerned in *Fabreeka*, provides a carefully drawn and detailed

formula for determining the amount of and the time for taking a deduction for bond premium,[7] whereas the interest deduction provision here in question (§ 163(a)) is more general in nature. Thus *Fabreeka* is far removed from the present case.[8]

2. *The Barnett and Ippolito cases.* As the two courts below noted, the Barnett and Ippolito dealings were even more obviously controlled by *Knetsch* than were Mrs. Goldstein's transactions. Not only were the loans to Barnett and Ippolito entirely without economic reality, but they were transparently prearranged with Gibraltar merely to add color to the large interest deductions. The Second Circuit felt it was correct to call the transactions shams, and decisions of the courts of appeals and the Court of Claims have consistently denied recognition to these patent types of simulated business loans. See *Jockmus* v. *United States,* 335 F. 2d 23 (C.A. 2); *Dooley* v. *Commissioner,* 332 F. 2d 463 (C.A. 7); *Lewis* v. *Commissioner,* 328 F. 2d 634 (C.A. 7); *Williams* v. *Commissioner,* 323 F. 2d

[7] Congress has subsequently amended the Code formula to prevent the abuse dealt with in *Fabreeka* by providing that bond premiums shall be amortizable to the maturity date and not to an earlier call date unless the earlier date results in a smaller amortizable premium. § 171(b)(1)(B)(ii).

[8] Petitioner argues that the present decision leaves *Stanton* v. *Commissioner,* 34 T.C. 1, in doubt (Pet. 21). Nevertheless, *Stanton* differs from the present case because there the taxpayer's "Treasury notes transactions would have been profitable before taxes, if events had happened as he anticipated they would at the time of entering into the transactions." 34 T.C. at 8. Here the evidence established both that petitioner had no such belief and also that any appreciable profit was impossible under objective standards (*Goldstein* App. 72a–77a).

656 (C.A. 9); *Gerstell* v. *Commissioner,* 319 F. 2d 131 (C.A. 3) (*per curiam*); *Nichols* v. *Commissioner,* 314 F. 2d 337 (C.A. 5); *Rubin* v. *United States,* 304 F. 2d 766 (C.A. 7); *MacRae* v. *Commissioner,* 294 F. 2d 56 (C.A. 9), certiorari denied, 368 U.S. 955; *Kaye* v. *Commissioner,* 287 F. 2d 40 (C.A. 9); *Becker* v. *Commissioner,* 277 F. 2d 146 (C.A. 2); *Lynch* v. *Commissioner,* 273 F. 2d 867 (C.A. 2); *Sonnabend* v. *Commissioner,* 267 F. 2d 319 (C.A. 1); *Goodstein* v. *Commissioner,* 267 F. 2d 127 (C.A. 1); *Broome* v. *United States,* 170 F. Supp. 613 (Ct. Cl.).

Petitioners' prepayments of "interest", followed in short order by rebates, were supported by neither an actual investment nor the creation of a genuine indebtedness. The government securities supposedly purchased by petitioners were originally delivered to a bank for Gibraltar's account and in exchange for its promissory notes. Gibraltar purported to resell them to petitioners. Less than 30 days later Gibraltar, as shown in its bookkeeping entries, purported to "repurchase" the securities from Barnett and Ippolito at prices below current market price. Those "repurchases" were not the products of any bargaining or consultation. Rather, they were accomplished without prior notice to petitioners, and the record is silent as to Gibraltar's method of unilaterally setting the "repurchase prices." Petitioners' alleged ownership and pledge of the securities as collateral for the "loans" was therefore manifested solely in Gibraltar's bookkeeping entries; they exercised no dominion over that property, nor did they

derive benefit from its purchase and sale. (*Barnett* App. 12a, 13a–15a; *Ippolito* App. 5a.)

The rapid and unsupervised turnover of the securities also demonstrated that Barnett and Ippolito knew at the outset that their "loans" would exist only for a short span of time. Nevertheless, they purported to prepay interest to cover periods relatively far into the future. Gibraltar was essentially a conduit to hold the "prepaid interest" on deposit for the few remaining days of one taxable year—thus lending credence to petitioners' claims to interest deductions in that year—only to return the money (less a fee for the service) almost immediately after the following year began. The purported purchases and dispositions of the government securities were only the means to give the flavor of reality to the "loans." As this Court said in *Knetsch*, petitioners' small out-of-pocket losses on the transactions were merely a "fee [paid to Gibraltar] for providing the facade of 'loans.'" 364 U.S. at 366.

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be denied.

Respectfully submitted.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1966

No. 728

KAPEL GOLDSTEIN and TILLIE GOLDSTEIN, *Petitioners,*

—against—

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

MAX BARNETT and ESTHER BARNETT, *Petitioners,*

—against—

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

MICHAEL J. IPPOLITO and AGNES IPPOLITO, *Petitioners,*

—against—

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

ON PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

PETITIONERS' BRIEF IN REPLY

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PETITIONERS' BRIEF IN REPLY

Respondent's brief has sought to envelop petitioners' case in a welter of misstatements and irrelevancies. When these are stripped away, it becomes apparent that he has but corroborated petitioners' thesis that the "principle" of the Court below not only conflicts with the view of other Courts of Appeal but is inherently unworkable and mischievous. In espousing it, respondent is really urging this Court to let him say, without objective standard or restraint, who may deduct interest on indebtedness and who may not. Therein lies a real potential for discrimination and for disruption of the market for securities of the United States.

1. Respondent's specious recitals that petitioners "purported" to purchase and "purported" to resell, that they "exercised no dominion over the property" (Resp. 13) trample the simple facts of the case. Respondent's innuendos would apply with equal validity to the many thousands of margin transactions in securities consummated daily, which respondent recognizes for Federal tax purposes. These purchasers never see their securities either; the securities are delivered to banks as collateral for the unpaid balance of the purchase price. The owners see only memoranda which mark their legal rights and obligations. Like other purchasers on margin, these petitioners bought their securities at prevailing market prices and hypothecated their securities for the margin they borrowed through their broker. They had no need or purpose to do anything else. Respondent's attempt to distort the commonplace facts shouts its irrelevance.

Respondent's assertion that the resales of Barnett's and Ippolito's securities "were not the products of any bar-

gaining or consultation" and "were accomplished without prior notice to petitioners" (Resp. 13) is equally without meaning or substance. Elsewhere, respondent concedes that Gibraltar charged petitioners "slightly more" than it paid for the securities (Resp. 4)—in actuality, 1/32 more, the normal dealer's charge for acting. The sales were similarly made at the then market, pursuant to unrecorded telephone orders, as is the everyday custom in the financial community.

Both Gibraltar's officers and the taxpayer's accountant testified categorically that there was no prearrangement of any kind with respect to the transactions (see Appendix). No prearrangement or irregularity of any sort was essential to petitioners' transactions, and none occurred. Respondent's statements are but a pretext—a senseless one, considering that the dealer, Gibraltar, was earning an interest differential of ½%, or more (Pet. Br. 22-26), on the moneys it had borrowed from Cleveland Trust and reloaned to the petitioners. The callow insistence that Gibraltar voluntarily and unilaterally deprived itself of this income is not only contrary to the testimony that there were no prearrangements—i.e., giving Gibraltar the right to sell petitioners' securities—but to the reasonable inference that the dealer would not act against its own interest.

Respondent, innocently or deliberately, confuses the instant case with others, of which he cites in a whole array (Resp. 12-13), which are distinguishable in a single overriding fact: In each, the broker funded the taxpayers' transactions *by selling the same securities short,* delivering the taxpayers' securities against its sale and applying the proceeds to pay for the securities the taxpayers had bought. The short sales were imputed to the taxpayers

by the Courts, nullifying their investments (see *Stanton* v. *Comm.*, 34 T.C. 1, 9; *MacRae* v. *Comm.*, 34 T.C. 20, 27). In the instant cases, there was no such nullification; the securities purchased by the petitioners remained in the hands of the lender banks throughout the duration of the subject transactions and the banks' money remained committed to petitioners' transactions. Since it is inconceivable that respondent cannot recognize this all-important distinction, it is apparent that what respondent really objects to, under all the smokescreen, is the avoidance of tax, and that he seeks to bar such avoidance even when achieved through valid transactions.

Petitioners have done what they, like all other taxpayers, have a right to do—purchase government securities and put them up as collateral for a loan. They had no need for any devices or sham to accomplish their purpose. If they had, through senseless masochism, resorted to unneeded devices, the far-reaching issue their cases present would still abide, its ghost unlaid.

The real core of petitioners' cases lies in the fact that they paid more to carry their United States securities than those securities, in turn, yielded them. Respondent would raise dire implications from this, but the inexorable fact is that the yield petitioners obtained was the yield *everyone* received who purchased the particular securities at the same respective times; and the price petitioners paid for their borrowing was the going rate for loans from banks at that time. Of course, the two are not the same. The yield of United States securities represents the basic or "pure" rate of interest. Banks pay their depositors more than this rate and, of course, they must make a profit on their lending operations. The "prime rate" of interest at

present, charged by banks to the best-rated customers is 6% (and very few can borrow at this rate); the New York Times for December 27, 1966 shows that yields on United States securities the previous day ranged from 4.02 to 4.93%

Respondent seeks to distinguish the *Stanton* case from the instant cases (Resp. 12, Fn. 8), yet he cooly ignores the fact that Stanton, a member of the New York Stock Exchange, had to pay 3% interest to the banks on his $5,000,000 borrowings, approximately twice the yield of 1.55% afforded by the United States Treasury Notes he had purchased, and which had but two years to run to maturity.

Respondent would distinguish *Stanton* on the Tax Court's finding there in that his "Treasury notes transactions would have been profitable before taxes if events had happened as he anticipated . . . " (that is, if the banks had permitted Stanton to prepay notes that contained no prepayment clause). Respondent therein makes petitioners' case. Stanton's experience demonstrates that profit apart from taxes is possible through the swing of the market for United States securities; petitioners' securities were traded in that same market and they too might have had a pre-tax profit, had the market gone right. Surely, respondent would not have the interest deduction hinge on the hind-sight fact that Stanton could have had an actual profit. (Petitioner Barnett herein would have had a pre-tax profit had he had the foresight to hold his bonds an additional month. But that is irrelevant.) These petitioners, like Stanton, borrowed hard cash from banks to pay for property purchased and one borrowing was "indebtedness" like the other.

2. The issue here is whether the petitioners' presumed motive disqualifies their indebtedness. There are no adequate standards in the opinions below, or elsewhere, by which a person's motives may be truly weighed in these particular circumstances, wherein a taxpayer understands that any loss sustained will be salvaged by the interest deduction. *It must be presumed* in these circumstances that the taxpayer knows about the effect of the deduction and has acted with normal self interest in the expectation that his loss will be redeemed.

The opinions below provide no objective standard by which the Courts, much less a Revenue Agent in the field, may distinguish validly between fair and foul, the pure-minded and the base-minded. Respondent has recognized this in terms, although perhaps not its implications. Arguing that the principle of these cases "is essentially a restatement of the core of the *Knetsch* ruling", he continues (Resp. 9):

> "The principal difference is that the instant opinion would allow a deduction when a transaction *does not comply with objective* standards yet the taxpayer had actually believed that there was a real possibility of economic benefit . . . " (emphasis supplied).

Respondent fails to recognize that the law cannot be administered fairly without objective standards; that it is impossible to know with any valid degree of certainty what a Stanton "actually believed" in this situation any more than what a sweepstake winner—or the ordinary investor—believed, whether one was motivated by the certain knowledge of redemption from loss by the interest deduction and

the other not. With this admission as to the true meaning of these cases, respondent stands before this Court as one asking *carte blanche* to say who shall have the interest deduction and who not . . . in short, to discriminate against a class of taxpayers like these petitioners and who ever else might grate upon his partisan sensibilities—or else, wholly to nullify section 163 in so far as it would apply to obligations of the United States by refusing the deduction to all who must pay 7% interest (the present margin rate) to support a yield of 4½% on such securities.

Respondent's own candid expression of the meaning of these cases reveals the urgency of intervention by this Court.

3. Having conceded that the test in this case is not grounded on any objective standards, respondent at once tries to distinguish *Fabreeka Products, Inc.* v. *Comm.*, C. A. 1, 294 F. 2d 76 (which petitioner has shown to be in conflict with this case (Pet. 16-17)), in that Fabreeka's "purchase and ownership of the bonds did not lack substance under objective standards" (Resp. 13).

That was not what respondent argued in *Fabreeka;* there, as here, he argued the transactions were "sham". But here, as in *Fabreeka,* the taxpayers purchased securities just as thousands of taxpayers do everyday, with full legal effect. The real core of respondent's position is clearly revealed in this argument. It is not any lack of substance in petitioner's purchase and ownership of the securities or lack of reality in the borrowing to pay the purchase price that taints the transactions for respondent. The tax avoidance motive is the real burr. There the ultimate issue rests. On that issue, the conflict between the cases is clear and undeniable.

That the identical issue has arisen on variant facts and statutory provisions attests its pervasive importance. Notably, respondent has not challenged petitioners' demonstration of that importance, made crucial by the unrealistic and mischievous "principle" adduced by the Court below. The importance of the question—for the market in securities of the United States and for investors, as well as for these taxpayers and for the orderly administration of the revenue—solicits the hearing of the within cases by this Court.

CONCLUSION

For the reasons stated, the petition for writs of certiorari should be granted.

Respectfully submitted,

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APPENDIX

Excerpts From the Record*

* * * * *

(Direct examination of Mr. Jack Bernstein, Vice-President of the dealer, Gibraltar Financial Corp.)

Q. Mr. Bernstein, were there any oral commitments, understandings or arrangements at that time—and I fix the time as on or about December 23, 1955, give or take back or forward several days—between Gibralter and Mr. Ippolito or anybody representing Mr. Ippolito as to how long Mr. Ippolito was going to hold those bonds or maintain its loan account with you? A. No.

* * * * *

* * * * *

Q. When you talked with Mr. Bourne on the telephone, did you give him any assurances that the amount of the loan would be shortly liquidated by Gibralter Financial

Corporation? A. I can't recall that assurance, no, sir.

* * * * *

(Direct examination of Mr. Milton Zipper, C. P. A., accountant for petitioners Barnett and Ippolito)

* * * * *

Q. Mr. Zipper, at the time that you placed the order with Gibralter for the purchase of Treasury Certificates, did you have any commitment, understanding, arrangement

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* *Ippolito* v. *Comm.* It was stipulated in the *Barnett* case that the proof in *Ippolito* applied to it as well.

or any similar indication to Gibralter or Mr. Bernstein as

—41—

to how long your client was going to hold those bonds, those certificates, or how long the loan would remain in force, and I place, I fix, the time as on or before December 23rd, the date when the order was placed. A. There was no arrangement other than the fact that the note itself ran for one year.

Q. Was there any arrangement to terminate sooner than one year? A. No, not at the time of purchase.

Q. Was there any arrangement to terminate when the bonds or certificates hit a specific price?

Mr. Kamp: I object, your Honor, on leading questions. He has been leading the witness. I would rather have the witness testify to it of his own knowledge.

The Court: The objection is overruled. Proceed.

Mr. Delson: Would you read the last question, please?

(Question read.)

A. No.

Q. I ask you that same question, Mr. Zipper, now fixing the point in time to December 27, 1955, which was the date shown on the note which the petitioner here executed. Was there any arrangement at that time when the signed notice was transmitted to Gibralter? A. No.

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